When Your Broker Might Not Really Be Your Friend

by Paul A. Merriman
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Government regulators have uncovered a giant mutual fund scandal in which millions of investors have lost millions of dollars. But investors lose much more money than this every year at the hands of people they trust to give them financial advice. This article tells why those losses occur and how investors can avoid or minimize them.

BROKERS ARE PAID BEST WHEN THEY SELL WHAT THEIR CLIENTS WANT AND NEED THE LEAST

Here's the bottom line: Brokers have nearly inevitable conflicts of interest with their clients, and they work in a corporate culture where sales come first and customers come second. As a result, I have started recommending that investors stop doing business with brokers altogether and instead work with independent advisors who don't sell products.

I've been involved with Wall Street since 1963. I once was a broker, and I have brokers among my friends. For the past 20 years I've worked with thousands of investors, many of whom have shared with me their experiences with brokers.

A brokers' job is to sell. But my job is to teach, and I spend the majority of my work time doing my best to show investors how to be successful, either on their own or with professional help.

Even investors who use independent advisors need to know what they are trying to accomplish and how they are trying to accomplish it. I subscribe to what could be called the Golden Rule of investing: "Don't invest in anything that you don't understand.'

It's very hard to follow that rule when you rely on a broker for advice.

I want to emphasize my belief that any investor who uses the services of a professional should expect to pay for those services. All advisors, including brokers, deserve to be paid.

But just how that advisor is paid is crucial. The method of compensation should not create a conflict of interest between the advisor and the client. Unfortunately, conflicts of interest are almost inevitable when the advisor's pay depends on what particular product the client buys, and when that broker works in a sales-driven culture interested in maximizing commission income.

It's no secret on Wall Street that the highest commissions are paid on products that are hardest to sell – and those products are often complex and quite risky. For example, some variable annuities may pay commissions of 10 percent or more, while simple money-market funds typically pay 0.25 percent.

This gives brokers a strong incentive to persuade investors to buy complex, high-risk products. Yet most investors don't want to take much risk, if any.

Result: Brokers get paid best for selling what their customers want and need least. Unfortunately, most investors don't understand this. Far too often, investors behave as if their broker were their friend instead of a salesperson.

TODAY'S FUND SCANDALS

In connection with the current mutual fund scandals, many investors think they've been betrayed by several big fund companies, and they're bailing out of tainted load funds and investing elsewhere. Some, having been burned by lax managers and illicit traders, are now being taken to the cleaners by their own brokers.

I have an old friend in the brokerage business named Max. He has many clients with positions in Putnam funds, reflecting the fact that Putnam was the most popular load fund family when he went into the business. (Remember that for a later discussion of investment fads.)

Shortly after Putnam was implicated, I asked Max what he was recommending to his Putnam clients who wished to put their money in other fund families. He told me he felt a little bit guilty about it, but he was recommending that they move into Franklin Templeton funds and Oppenheimer funds, giving Max the opportunity to earn an additional 5.75 percent commission by selling them Class A shares.

I asked why he wasn't recommending American Funds. Max and I agree that American is one of the more investor-friendly load funds, partly because they charge lower ongoing expenses than many others.

Max admitted that his clients would likely do better with American funds. But he said his employer charges him $50 for every purchase he makes in American funds – and Max is not willing to pay that $50 charge out of his pocket.

Here's the math: Assume that an investor with $20,000 in Putnam wants to get out and move into another fund family. If Max sells the client a fund with a 5.75 percent load, he can make a commission of $1,150. But if the money goes into American Funds, Max would have to give back $50 of that commission to his employer. Max would rather keep that $50 than put his clients in a fund he believes will do better for them.

Conflict of interest? You bet!

(Load fund families typically reduce the percentage commissions, in steps, on Class A shares for larger investments. American Funds, for example, reduces the commission to 5 percent on investments over $25,000 up to $50,000. Investments of $1 million or more in Class A shares are commission-free if the shares are held at least one year.)

But it gets worse. Max said a friend of his who works for another large brokerage firm told him that his employer is encouraging brokers to move clients' money from Putnam into other load funds by the end of this year in order to meet sales goals and fatten bonuses.

So at least one part of Wall Street has decided to turn the ill fortune of some fund families into a profit center. This also gives the industry a huge incentive to play up the scandal.

But it gets even worse than that. When I first talked to Max, he wasn't aware that he could move his clients' money out of Putnam and into other load families, including Oppenheimer, without charging them any commission at all.

This maneuver is called an NAV transfer, reflecting the fact that some load fund families will accept investments that have moved out of other load families at the net asset value. To qualify, the transfer must occur within 30 to 90 days from the time the client sells the old load fund. The time limits vary from company to company.

This isn't something brokers do as charity. Some fund families pay the broker 1 percent of the money they bring in through an NAV transfer – and the money does not come out of the investor's pocket.

I understand that these NAV transfers are available at several fund families, including Oppenheimer, Hartford, Columbia, First Eagle, Phoenix and Thornburg. There are undoubtedly others. American Funds, however, does not accept NAV transfers.

Because Max wasn't even aware of the possibility of an NAV transfer, his clients didn't have that option. Instead, they may have taken Max's recommendations and paid an entirely unnecessary commission.

In a second conversation with Max, I told him about NAV transfers. He said he'd check into it and said he'd be happy to receive 1 percent on such transfers.

This is fine, but Max's clients should not have to rely on the lucky break that somebody happened to tell Max something he could do for them. His clients count on him to be competent and informed. In this case, he was not informed enough to be competent on their behalf.

THE A-B-C's OF FUND SHARES

Load funds used to be simple: Investors paid a sales commission up front. Currently the standard commission is 5.75 percent. That means the investor's account starts with only 94.25 cents for every dollar invested. And that means the fund has to appreciate by 6.1 percent just for the investor to break even.

That's the model for what are known as Class A shares. "Class A" doesn't have anything to do with quality. Share classes relate to something the industry is more interested in: how the broker gets paid by the shareholders.

When investors started balking at up-front commissions the industry invented Class B shares. They don't charge an up-front sales commission, and every dollar the investor pays goes into the account.

As you can imagine, investors like that, and these shares are easier for brokers and advisors to sell. But there's a catch – a very important one.

I don't think most people who invest in Class B (and another type called Class C) shares understand what they're doing. What most of them don't know is that Class B and Class C shares inflate their expense ratios – and thus degrade their performance – in order to pay brokers the very commissions the investors think they are avoiding.

In addition, Class B shares impose an early-exit fee on shareholders who sell before a certain time period, typically seven years.

There's another Catch-22 hidden in Class B and C shares. Because their higher expenses are based on the value of the shares, whenever those shares experience more than modest growth (which is of course what investors hope for), those shares almost certainly will cost the investor more than the up-front sales charge.

Even though it's extremely important, brokers rarely spend much time making sure their clients understand all this. When all the customer wants is performance, why go out of your way to explain that these easy-to-sell shares will provide less of it?

Again and again, we see cases in which the clients lack important information. They don't know their broker would willingly compromise their interests to avoid losing $50 of a fat commission. They don't know their broker could transfer them into another fund family without any sales commission. They have no idea that the broker may be recommending shares that will cost them more money.

In my mind, there's no question which choices investors would make if they knew all the facts. Almost without exception they would choose funds that minimized fees, commissions and expenses. But the typical client never gets those choices, never sees the conflicts of interest.

I am not alone in concluding that brokers fail to serve their clients well. According to an article in The Wall Street Journal, a survey of wealthy Americans (defined as those with at least $5 million in investable assets) indicated that their reliance on brokers dropped about 27 percent from 2001 to 2003. The percentage of those people who used a full-service broker declined from 41 percent to 30 percent in those two years.

Common objections to dealing with brokers included the belief that their advice is intended more to make money for the brokers and the firms than to make money for the client. Wealthy investors also disliked the feeling that certain products were being pushed on them.

Meanwhile the percentage of such investors who used independent money managers instead of brokers doubled, from 7 percent in 2001 to 14 percent in 2003. I believe that is a healthy trend.

When Your Broker Might Not Really Be Your Friend (continued)

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Continued from When Your Broker Might Not Really Be Your Friend Part I

SALES PRESSURE

Here's part of an email I recently received from a former broker: "I entered this business being quite idealistic, thinking I could actually do people a service. I quickly realized that was going to be nearly impossible, since my managers only cared about the month-end commission report."

Brokers work for local sales managers, who have quotas and targets to meet. Those sales managers in turn must report to regional sales managers, who report to a national sales manager.

In the end, top national brokerage executives earn up to $100 million a year by deciding which products must be sold at the regional and local levels – and by demanding performance all the way down the line.

Result: conflict of interest. If my friend Max has a client whose needs would be perfectly met by Treasury bills, Max is more likely to be reprimanded than rewarded if he suggests T-bills. His real job is not to solve clients' problems. Max's real job is to sell them products.

When brokers put their clients' money in mutual funds, they could choose funds with the lowest costs. But instead, all too often they choose ones with higher costs. Why? In some cases because they don't care or don't think it makes any major difference. In other cases … well, I'd like to share with you some email messages I received as I was working on this article. They responded to two columns I wrote for CBSMarketwatch.com.

"I used to work at First Union Securities and A.G. Edwards, and I'm now independent. The managers in large brokerage firms put enormous pressure on their stockbrokers to 'produce.' There are a lot of good, well-meaning brokers at these large retail brokerage firms who would like to recommend investments such as the ones you mentioned in your article. But they find themselves nearly coerced into recommending the higher commission products by the management of these firms. The only way that a broker can truly work in a client's best interest in this day and age is to become independent."

One day later, I received an email from an independent investment advisor (formerly a broker) who said he has 28 years of experience and has made friends with securities wholesalers, who sell mutual funds and other products to brokers.

This advisor told me that the branch managers at many brokerage houses often dictate which wholesalers are allowed to see brokers and which ones are turned away. My correspondent had just received a voice message from a wholesaler whose employer was requiring him to sponsor a golf tournament for brokers.

Much of the cost of the tournament would have to come out of the wholesaler's own pocket, but it was his only chance to speak to brokers about his company's products.

Remember: It's unquestionably in the best interests of investors to choose mutual funds with low expenses. Again, I ask the question: Why do brokers recommend higher-priced funds? One reason could be that funds which charge their shareholders higher expenses can afford to be more generous to brokers.

IGNORANCE

As I've shown, most brokerage clients don't know all the facts. One reason is that they don't take the time to study materials that the law requires they be given. And clients lack vital information, such as exactly why the broker is making certain recommendations.

Ignorance isn't exclusive to clients. Most brokers either fail to understand how investing really works or (if they do understand it) fail to take advantage of that understanding on behalf of their clients.

One of the best ways to get a premium return is through wide diversification. But if brokers understand that, they certainly don't act like it.

I don't know that I've ever seen a brokerage client whose portfolio is as widely diversified as it should be. The portfolios of most brokerage clients, whether they own individual stocks or mutual funds, are heavily overweighted in large-cap U.S. growth stocks. Yet large-cap growth stocks have the worst performance among all major equity asset classes over the past 80 years.

Rare indeed is the broker who takes the time to persuade his or her clients to have a mix of large companies and small companies, growth companies and value companies, U.S. companies and international companies.

SELLING WHAT'S POPULAR

Across the board, brokers are most likely to sell what has been performing well recently, because performance is easy to sell. The bargains in the market are always stocks and funds that are out of favor. But those stocks and funds carry high emotional risks. That makes them hard to sell. Popular stocks, even when they are overpriced, are easy to sell. Guess what kind of stocks brokers like to recommend!

Unfortunately, this stacks the deck against investors. It was largely this cult of recent performance that fed the frenzy that lured so many investors into Internet and wireless stocks in 1998 and 1999. When the bubble burst, investors who lost “only” half their money had reason to consider themselves lucky.

When brokers recommend stocks, they may be under pressure from above to unload issues in which their company may have a large inventory. This is especially true when it comes to initial public offerings underwritten by the company that employs those brokers.

There is no evidence that initial public offerings and other in-house products outperform competing products. So brokers don’t use that as a sales pitch.

However, brokers are eager to tell clients they can buy initial and secondary stock offerings without paying a commission. That’s technically true. But brokers rarely if ever volunteer the information that a larger-than-usual commission has already been built into the offering price of initial and secondary offerings.

Amid the excitement of selling such products, sales managers don’t care very much about whether or not it makes any sense for an individual client to own stocks that the brokerage is trying to unload.

A broker at one of the top three brokerage houses in the country once told me his quota of a certain IPO was so firm that his manager told him any shares he didn’t sell to clients he would have to buy himself.

THE FASHION BUSINESS

Few brokers would agree that they are in the business of selling what’s fashionable, but the evidence is strong that fads rule Wall Street.

How else could anyone explain the extreme popularity of Internet and wireless stocks – and the funds that specialized in them – in 1998 and 1999? Enormous sums were invested in companies with no operating history or products. This bubble is a good illustration of Wall Street’s desperate eagerness when there’s a chance to separate greedy investors from their money.

This brief era was only one in a long string of investment fads. In the 1960s, the rage was growth stocks related to the space age. In the 70s, after stocks tanked in a sudden bear market, bonds became the investment of choice – just before interest rates shot up to levels in the high double-digits. In the 1980s, at least until Congress closed some barn-door-sized loopholes in the tax laws, brokers fell all over themselves pushing limited partnerships.

In the 1990s, growth stocks regained their glory, and the mutual fund industry exploded. Fund salespeople were delighted to have an ally, Morningstar Inc., which assigns one to five stars to each fund.

Morningstar itself admits its rating system is not a reliable indicator of future performance. But that hasn't stopped fund companies and brokers from touting four-star and five-star funds as if that designation were very important. Most investors also don't realize that fund companies pay licensing fees to Morningstar in order to use their star ratings.

Advisors who use star ratings to sell funds either don't understand that they don't mean much (in other words, they are ignorant of something they should know) or they are deliberately misrepresenting the facts and misleading their clients. Either way, investors lose.

A VIEW INTO THE FUTURE

To gain people's confidence, brokers talk as if they know where the market is heading. A broker may point to his firm's research staff (usually in New York) and describe conference calls with top analysts who supposedly are in tune with the market's pulse.

Even though such analysis is mostly smoke and mirrors and subject to frequent changes, all that expertise can seem quite impressive to an ordinary investor. And brokers aren't shy about taking advantage of it, even though there is no solid evidence that analysts' predictions reliably help investors make money and avoid losses.

SUMMING IT UP

All these arguments and examples can be boiled down to a few assertions that I am sorry I must make:

Most brokers are trained, encouraged and compensated for selling products, not for solving clients' problems.

The investment world would be a far healthier place for investors if they understood and believed that every broker's real job is to bring in sales commissions. Solving clients' problems may be a satisfying byproduct. But that's not what brokers are in business for.

I am not arguing against getting professional help. The research consistently shows that investors who make their own decisions do relatively poorly. Of course there are always exceptions. But investors should expect their results to be typical rather than exceptional.

I believe investors should get the best investment and planning advice available. They are highly unlikely to get that from somebody whose job is to sell them commissioned products. A salesperson under pressure – and there are tons of them on Wall Street – has little time for thoughtful, complex topics like asset allocation and risk management.

I realize that I'm painting the brokerage industry with a broad brush. It's true that many brokers are ethical and competent. There are plenty who will go out of their way to do the right thing for clients, and those brokers have my admiration. If I knew a way to identify them, I'd be happy to recommend them.

But most clients simply have no way to know which brokers deserve their trust and which don't. I've been involved with this business for decades, and even I still do not know any reliable way to identify brokers who are truly worth trusting.

After 40 years of experience with this industry, I've concluded that investors need to turn elsewhere – somewhere besides the brokerage business – to get the level of help they need.

WHAT I RECOMMEND

Not much in life is certain, and investing is no exception. Basically, there are three choices:

- **Some things are guaranteed.** The return you'll get on a certificate of deposit or a Treasury security is one example. Investors who require certainty can get it, but at a very costly price. When the bank guarantees what it will pay on a CD, it assumes all the risk. In return for that, the bank promises to pay a very low interest rate.
- **Some things are probable though not guaranteed.** One example is the notion that stock funds will outperform bond funds in the future. There will always be periods in which the opposite occurs. But if history is any guide, it's more likely than not over long periods that stock funds will outperform bond funds.
- **Some things are possible, although not probable.** One example is that the stock you read about or that is recommended to you by somebody you know will turn out to be "the next Microsoft." In fact there is probably some relatively small, relatively new company on the market right now that, 10 or 20 years from now, will be an industrial giant. But out of 5,000 or so possible candidates, it's highly unlikely that you'll be lucky enough to spot that one future gem.

I don't recommend the first choice. Minimize your reliance on what's guaranteed, because there is no premium return for investors who take no risks.

I don't recommend the last choice. Luck is fine for small amounts of money that you can afford to lose. But it's foolish to stake your financial future on it.

I do recommend the middle choice. Forget what's guaranteed and forget what's theoretically possible. Instead, focus on what's probable. That is the "sweet spot" in investing, in which taking a carefully calculated risk is likely to pay off.

This applies to choosing advisors as well as investments.