10 Tough Questions You Should Ask Any Financial Advisor

By Ron A. Rhoades, JD, CFP® of Scholar Financial, LLC

In 2008 the SEC commissioned a report about broker-dealers and investment advisers. The report included a section on how consumers viewed their "financial advisor." The SEC highlighted that most consumers were satisfied with their financial services professional.

Yet, within the report was a startling fact. Thirty percent of the consumers who used financial advisors stated that they paid *no fees* to their advisor! In other words, they thought their broker was giving them recommendations for free. (Given that investment advisers provide written statements of their fees to their clients, typically quarterly, the percentage of clients of brokers (*i.e.*, registered representatives of broker-dealer firms) that didn't understand that they were paying fees was much higher.

I often review the investment portfolios of individual investors. During my analysis I uncover, and add up, the fees and costs of the investment products many brokers and insurance agents recommend. And I discern the likely compensation the individual investor has paid to, and continues to pay, to the broker-dealer firm or insurance company. When I reveal this information to the individual investor or foundation's investment committee or plan sponsor, the individual investor is often stunned.

Some of these individual investors believed that their broker or insurance agent was their "friend" and was providing all his or her recommendations "for free." Wall Street firms are masters at hiding their fees.

Far too many financial advisors today hold themselves out as "fiduciaries." While being a fiduciary is important, it is not enough for the consumer to ask just that singular question. The fact of the matter is, some fiduciary financial advisors today don't really understand, and apply correctly, the fiduciary standard of conduct. And, just as important, the fiduciary standard of due care is too low of a standard, as it requires just a "reasonable basis" for investment recommendations.

To aid consumers, I created this list of ten TOUGH questions every consumer of investment or financial planning advice should ask. Whether the consumer is an individual investor, plan sponsor, endowment fund manager, foundation investment committee member, or trustee.

> **To aid in your understanding the importance of each question (and, candidly, also as a means to promote my own firm), I provide my own responses to these questions (as the principal of Scholar Financial, LLC).**
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> **Let's begin … on the next page.**

What Questions Should I Be Asking a Financial or Investment Advisor? And … What Are Your Answers to Such Questions?

1. Will you and your firm be a fiduciary at all times during our professional relationship? And will you provide me with a copy of your Form ADV, Parts 2A and 2B, and your own public disclosure document?

Yes.

While being a "fiduciary" is very important, unfortunately in the United States the regulation of fiduciaries in the realm of investment and financial advice still permits many fiduciaries to possess substantial conflicts of interest. Much more is needed … read on.

Every investment adviser is a fiduciary, by law. As such, you should request from your investment adviser three documents for your review:

- Form ADV, Part 2A (the "firm brochure" that describes its services, fees, conflicts of interest, and more).
- Form ADV, Part 2B (information about the firm's individual advisors).
- Form U-4 (the financial advisor's employment history and a record of any disciplinary activity) is provided via an Investment Adviser Public Disclosure report.

2. Are both you and your firm a *fee-only* advisor?

Yes.

Why is this important? Under existing securities regulation in the United States, you can be a "fiduciary" and still sell investment and insurance products. This puts the financial advisor in a conflicted role – trying to represent the client (the purchaser of financial products) and the product manufacturer (the mutual fund company, insurance company, etc.) – at the same time.

In my view, it is just not possible to be a bona fide fiduciary if you wear "two hats" at the same time. No person can serve two masters.

Fortunately, there are many financial advisors who are "fee-only." They don't sell any investment or insurance products. As a result, the conflicts of interest they possess are far less numerous.

Conflicts of interest in financial services, truth be told, are best avoided, as it is very, very difficult to "properly manage" conflicts of interest.

My best advice to consumers … always seek out a "fee-only" financial and/or investment advisor. You can find them via the National Association of Personal Financial Advisors, XY Planning Network, Garrett Planning Network, and the Alliance of Comprehensive Planners.

3. Will you provide advice and/or management of my investment portfolio under the tough standard of the *prudent investor rule*?

Yes.

By way of explanation, the duty of due care a fiduciary investment advisor possesses generally requires that the investment advisor possess a “reasonable basis” for her or his investment strategy and investment product recommendations. What does this mean? Ask different financial and investment advisors, and you will likely get different answers.

As a result, Scholar Financial, LLC agrees to adhere not just to the fiduciary standard of due care, but also to the tougher “prudent investor rule.” (Adherence to the prudent investor rule shall not lower, nor abrogate, our duty of due care, in any way.)

While the requirements of the prudent investor rule are many, there are two key requirements that can be derived – and applied – to a client’s investment portfolio:

First, the requirement to avoid or minimize idiosyncratic risk, absent a good reason to assume such risk. In other words, through broad diversification, seek to eliminate or minimize the inherent risk of many individual securities (stocks, corporate bonds, etc.). To minimize terminal wealth dispersion (and improve the likelihood of the attainment of the client’s lifetime financial goals), this means diversification by holding hundreds, and even thousands, of different equities (stocks). (Broad diversification can also assist in tax-efficient investing, compared to concentrated portfolios of equity holdings.)

Second, the requirement to avoid a “waste” of the client’s assets. In my view, this means maintaining tight control over the fees and costs the client incurs in connection with various investment products. It also means seeking to minimize the long-term tax drag on an investment portfolio’s returns. It can also means avoiding or substantially minimizing permanent losses in a client’s portfolio that might be incurred due to a lack of adequate diversification.

(Note that Scholar Financial, LLC’s individual clients may choose to have the prudent investment rule not apply to a portion of their investment portfolio. For example, a client may desire to retain a significant stock position in one or more companies, even though that is not Scholar Financial, LLC’s advice.)

4. Are you a Certified Financial Planner™ (CFP®), Chartered Financial Analyst (CFA®), or a CPA/Personal Financial Specialist (CPA/PFS®)?

Ron is a Certified Financial Planner™ (CFP®). Why is this important? This is one of the three broad-based financial certifications or designations which, in Ron's view, denote the acquisition of a significant foundational knowledge of investments and financial planning concepts.

Ron is also an instructor for financial planning and investments courses to university students. He teaches courses in Personal Finance, Applied Investments, Estate Planning, Legal and Regulatory Aspects of Personal Financial Planning, and Financial Plan Development (capstone course). He has previously taught courses in Advanced Investments, Retirement Planning, Capital Markets, Principles of Finance, Risk Management and Insurance, and Business Law I and II. Ron also serves as Director of Western Kentucky University's Personal Financial Planning Program. (See https://ronrhoades.com/about/ for more information.)

There are literally hundreds of designations and certifications in financial services. Be certain to seek professionals with certifications that require hundreds, if not thousands, of hours of study – to ensure the certification "has teeth." The three certifications listed in the question, above, meet this requirement.

5. Will you NEVER recommend to me any proprietary product, nor any investment or insurance product for which you, your firm, or any affiliated firms receive any material compensation, including but not limited to commissions, 12b-1 fees, payment for shelf space, or any other form of revenue sharing?

Yes, I make that solemn commitment.

There is no need for a financial advisor today to recommend any proprietary product, nor to recommend investment or insurance products which benefit either the advisor, her or his firm, or affiliates of his or her firm.

There are many thousands of mutual funds, ETFs, and other investment vehicles in existence today. When a financial advisor works for an asset management firm or insurance company that manufactures investment products (such as mutual funds, ETFs, annuities, cash value life insurance, etc.), such a firm or company encourages the financial advisor to recommend proprietary products. This creates a conflict of interest that often taints the advice that is provided.

It is far better that the financial advisor be truly independent – and able to survey the entire universe of investment and/or insurance products to discern those few that best meet the needs of her or his clients.

Again, being "fee-only" means avoiding the conflicts of interest that result from recommending such proprietary products, and recommending products that pay commissions or provide revenue sharing to the advisor or her/his firm (or affiliates).

6. Will you utilize an independent custodian (such as an discount broker-dealer firm, such as Schwab, Fidelity, Vanguard, etc.), and will you avoid taking custody over my assets (except for deduction of fees supervised by the independent custodian), in order to better ensure that my investment assets are protected? Will you ensure that the independent custodian provides to me, directly to me from the independent custodian, monthly or other periodic reports that verify my holdings?

Yes.

Please be aware that Scholar Financial, LLC (as are most independent investment advisers) is provided, with respect to accounts its clients hold at Charles Schwab, and with client consent, the ability to deduct our fees from clients' accounts. In certain instances (such as traditional IRA accounts), this can be a tax-efficient means of paying for our services. In all such instances, the custodian (Schwab) monitors fee deductions from client accounts to seek to spot any irregularities.

Why is this important? Having an independent custodian, who directly provides clients with statements on their accounts, is an important safety measure for you, the client. This substantially diminishes the risk that your "financial advisor" (however licensed) might engage in theft of your assets or engage in a "Ponzi scheme."

It is a best practice for you to always review your monthly (or quarterly) statements from the independent custodian. In short, "trust ... but verify."

If you detect unusual activity, or a transaction that you don't understand, query your advisor. If suspicions remain, seek a second opinion from a different advisor – quickly.

If you detect any theft or other taking of property from you, don't hesitate to contact a federal or state securities regulator.

The North American Securities Administrators Association (NASAA) provides an excellent list of "warning signs of fraud."

The U.S. Securities and Exchange Commission regularly provides "Investor Alerts and Bulletins."

7. Will you provide to me a summary of the academic evidence that supports the investment strategies that you recommend to me?

Yes.

Scholar Financial, LLC utilizes "evidence-based investing" as its core investment philosophy.

A summary of evidence-based investing is provided in the Investment Policy Statement we prepare for each of Scholar Financial, LLC's clients.

Evidence-based investing will be explained, in detail, in Professor Rhoades' forthcoming book, *Mastering the Science and Art of Investing: Multi-Factor Strategies for Portfolios Both Prior to and*

During Retirement, expected to be published in early 2024. Some of the concepts are explained, in summary fashion, in Professor Rhoades' blog posts.

8. If I engage you to design and/or manage my investment portfolio, will you provide me with an Investment Policy Statement that describes the investment strategy recommended and which establishes a strategic asset allocation for me?

Yes.

Why is this important? While not required by law, every individual investor (or trustee, or endowment fund manager) should possess an Investment Policy Statement. Not only does your investment advisor agree to abide by its terms, but the document also can provide you with a plan for what will occur when market valuations go substantially up, or down. This helps you – and the investment adviser – adhere to the discipline of strategic asset allocation and portfolio rebalancing.

An Investment Policy Statement can be one pages, or many, many pages. It usually addresses the time horizons over which the investment portfolio is to be utilized. It also sets forth a strategic asset allocation (by asset classes, and/or by specific investments). The Investment Policy Statement also typically identifies types of investments which the investment advisor will not invest in.

An Investment Policy Statement provides the client with assurance that the portfolio will be managed by the investment adviser under a defined set of criteria and a common understanding.

9. Will you provide to me a written estimate of the total fees and costs (including your investment advisory fees, annual expense ratios of mutual funds and ETFs, and transaction costs relating to trading – either by you or by mutual funds and ETFs or other pooled investment vehicles that you recommend to me) that I will incur in connection with my investments?

Yes, upon request by any client.

Scholar Financial, LLC has several programs for clients. Our most common engagement for individual clients is under our "SF Wealth Advisory Program," in which we provide comprehensive financial advice over time, combined with investment portfolio management, for individual clients. Our highly competitive fees are 0.5% of the first $2,000,000, and 0.15% of the amounts over 0.15%. We keep our fees low by avoiding many of the underlying infrastructure costs incurred by larger firms, and we concentrate on providing services that truly add value to our clients.

Institutional clients (endowment funds, etc.) and trustees of irrevocable trusts are provided fees of 0.40% of the first $3m, and 0.15% thereafter, for investment advisory and portfolio management services.

Further information on all of Scholar Financial, LLC's programs, services and fees can be found in our Form ADV, Part 2A, available upon request. Simply email AdvisorIno@ScholarFinancial.com and we will be pleased to send you a copy of same.

Scholar Financial, LLC, as part of its due diligence, seeks to identify mutual funds, ETFs, and other investment and insurance products which possess very low total fees and costs, as academic research has concluded that the higher the fees and costs of an investment (relative to other similar investments), then (on average) the lower the returns provided to the owner of that investment product.

There are many "hidden" fees in pooled investment vehicles (mutual funds, ETFs, etc.), including various transaction costs and opportunity costs. While these hidden fees cannot always be quantified, they can be estimated.

By combining all the fees and costs associated with the management of your investment portfolio and the products within it, you can be provided a total fees and costs estimate.

Scholar Financial, LLC's goal is that the *total fees and costs* incurred by our clients, for comprehensive financial planning and investment portfolio management, is well under 1% annually, and it is often far less for much larger portfolios.

10. Will you design and manage my investment portfolio with a view toward long-term tax efficiency, to reduce the "tax drag" upon investment returns?

Yes.

Scholar Financial, LLC regards tax-efficient investment portfolio design and management as essential for nearly every client.

I remain aghast at the large number of brokers and investment advisory firms that don't engage in tax-efficient portfolio design and management. It is not what you make, it's what you keep – after fees and taxes – that is most important.

In general, tax-efficient portfolio management aims to minimize taxes on investment gains and income while still achieving the investor's investment goals. Some of the strategies commonly used to achieve this include tax-loss harvesting, asset location optimization, and tax-efficient fund selection.

According to various studies, tax-efficient portfolio management can add between 0.5% and 1.5% annually to after-tax returns, depending on the circumstances. For example, a study by Vanguard found that tax-efficient strategies added an average of 0.75% annually to after-tax returns for a balanced portfolio of stocks and bonds.

(Certain clients, such as endowments and foundations, are exempt from tax concerns.)

BONUS QUESTION: Will you, upon my request from time to time, put the answers to my questions above (and any others I possess) in writing?

Yes. See the above!

> **IF A FINANCIAL/INVESTMENT ADVISOR AND HIS/HER FIRM DOES NOT ANSWER AFFIRMATIVELY TO ALL OF THE QUESTIONS SET FORTH ABOVE, OR STATES THAT THEY CANNOT PUT THEIR ANSWERS IN WRITING, THAT IS A HUGE RED FLAG (WARNING SIGN) TO YOU!**