

## Choosing A Financial Planner - Titles, Credentials & Compensation<sup>1</sup>

*Of the many pieces we've read over the years about the professional (and not-so-professional) financial and investment environment, the following piece from Vanguard's website stands out as the most informative and understandable. The Vanguard Group has been leaders in bringing cost-efficient investment management services and products to the investing public. Vanguard's reputation as a revolutionary force in making the investment business more competitive is undeniable and well deserved. (We have no marketing arrangement with Vanguard, but depending on a client's needs and situation, we may recommend using a Vanguard fund or low-cost annuity.)*

### Looking Beyond Titles and Credentials

In your search for expert help, you will come across a variety of job titles, including not only the title "financial advisor" but also titles such as financial planner, financial consultant, or even account executive. However, it's important to keep in mind that anyone can use generic titles such as these, regardless of his or her training or education.

You may also find yourself adrift in what has been called an "alphabet soup" of credentials—CFP, CPA, PFS, CFA, and ChFC, for example. Focusing on advisors who have credentials is usually a good idea because having a professional designation suggests a commitment to the field based on some combination of work experience, formal study (including passing qualifying exams in their field), and continuing education.

But no professional credential or job title can guarantee the quality of an advisor's services or ensure that your needs will be met. Moreover, the primary interest of some advisors may be to sell you a particular financial product rather than to provide impartial guidance. So, in your search, look beyond job titles or credentials by gathering other information to ensure that the advisor you choose will be the right one for you.

Most financial advisors come to planning from a sales job. One of the first things the good ones learn is to leave their sales hat at the door.

—Mary Rowland, *Best Practices for Financial Advisors*, 1997.

The following explanations will help you thread your way through the best-known professional credentials and the types of advisors who may hold them (and some may hold more than one):

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<sup>1</sup> Excerpted and adapted from "How To Select a Financial Adviser" – The Vanguard Group

- **Certified Financial Planner® (CFP®).** This designation is awarded by the Certified Financial Planner Board of Standards to individuals who have had at least 3 years of work experience in the financial planning field, completed an approved course of study, and passed a 2-day exam. The training of CFPs, which focuses on financial planning, includes taxes, investments, retirement planning, estate planning, and insurance.
- **Certified Public Accountant (CPA).** Business accountants, some of whom specialize in personal tax planning and preparation hold this designation. To qualify for the CPA credential, they must pass a 2-day examination administered by the American Institute of Certified Public Accountants (AICPA) and meet state licensing requirements relating to work experience and, in most states, special academic work. CPAs may also earn the AICPA's financial-planning designation of Personal Financial Specialist (PFS), which is awarded based on work experience in financial planning and successful completion of a PFS exam.
- **Chartered Financial Analyst (CFA®).** This designation is awarded by the Association for Investment Management and Research to investment professionals who have worked in the investment industry for 3 years and have passed each of 3 yearly exams involving securities analysis and professional money management.
- **Chartered Financial Consultant (ChFC).** The American College of Bryn Mawr, Pennsylvania grants this financial-planning designation. Candidates for the ChFC must have completed a 10-course curriculum and have worked in the financial services field for at least 3 years. Many ChFC candidates are insurance agents who have also earned the Chartered Life Underwriter (CLU), an advanced insurance credential, from the college.
- **Registered Investment Advisor (RIA).** This designation is neither an indication of expertise nor a license to buy or sell securities. It merely indicates that an individual, or his or her employing firm, was required under federal securities laws to file (for a nominal fee) with the Securities and Exchange Commission or a state securities commission for a license to dispense investment advice.
- **Registered Representative.** Securities brokers who have passed mandatory basic exams given by the National Association of Securities Dealers, a regulatory body for the securities industry, hold this designation. Securities brokers recommend investments for clients and execute client orders to buy and sell securities such as stocks, bonds, options, and mutual funds.

## Understanding How You'll Be Charged—And Why It Matters

To judge the value of an advisor's services, it's important to understand how the advisor is compensated and what the total costs are that you're likely to pay. Some costs may not be obvious—leading some advisers to promote their services as "free." Because almost nothing is free, it's prudent to always **ask for a detailed explanation**. If you don't fully understand the compensation arrangement, probe for more information until all the details are clear to you. A reputable advisor will be completely open and forthright when discussing compensation.

Always ask what an advisor charges, what the fees are based on, and how much your specific job is likely to cost. There's nothing indelicate about these questions; no professional will blush at them.  
—Lynne Brenner, *Smart Questions to Ask Your Financial Advisers*, 1997.

Generally speaking, advisors are compensated through either commissions or fees.

- **Commission-only advisors** earn their income by selling financial products such as insurance or certain types of mutual funds, or by executing securities trades.
- **Fee-only advisors** earn their income through—as their name implies—fees (based, for example, on an hourly rate, a flat annual or single-project amount, or an annual percentage of assets).

But some advisors may receive income from both commissions and fees. (Some of these advisors may therefore say their compensation arrangement is "fee-based," not to be confused with "fee-only" arrangements.) Other advisors will reduce their fees by the amount of investment commissions they receive on products you buy from them. Advisors may even be compensated through noncash sales incentives, such as free vacation trips.

Moreover, some compensation arrangements are subtle. Commissions on mutual fund purchases, for example, aren't always paid from a visible up-front sales charge (load). Instead, a fund may use a portion of operating expenses to pay commissions—which investors never see—to financial advisors. That's why you should review the expense ratio section of a fund's prospectus. There, the prospectus discloses whether the fund charges a 12b-1 fee, which it uses to recoup marketing and distribution costs, such as commission payments to advisers.

In the case of insurance products, you typically won't be told how much commission (also called a load) the agent or broker will receive from the premium payments you make—you'll have to ask.

There may be other types of expenses as well—commissions on the purchases and sales of stocks and bonds, for example, or legal fees for the drafting of documents in an estate plan. When you talk to potential advisors, therefore, ask about all the fees, sales charges, and other costs that you will have to pay, both directly and indirectly.

## Fee Arrangements

Fee arrangements will differ depending on whether an advisor works with you for a short period on a specific aspect of your financial situation, or works with you on an ongoing basis.

- **One-time fee.** An analysis of your income and insurance needs as you plan for retirement, the development of an investment plan based on your financial goals, and the creation of an estate plan that your attorney can then implement are examples of specific, one-time analyses that an advisor can provide. The costs of these analyses typically range from \$500 to \$7,500, although they could run higher or lower. (Such plans will have to be updated from time to time, especially if your circumstances change.)
- **Ongoing fees.** Advisors can also provide ongoing planning and guidance, including managing money for you. Yearly fees, often based on a percentage of assets under management, may be as

low as 0.65% (\$650 per \$100,000) or as high as 3% (\$3,000 per \$100,000) and may be based on a sliding scale (the more assets managed, the lower the percentage charged).

Keep the following two points in mind as you evaluate advisor fees. Many advisors charge minimum fees, which may simply be too high when you consider the value of the assets you'll be asking the advisor to handle for you. (Some advisors may even decline your business if your assets aren't high enough in value.) And importantly, paying higher fees doesn't necessarily get you better service. A competent and trustworthy advisor whose fees are at the lower end of the scale may be as good as or better than a more expensive advisor.

### **Commissions versus Fees: Cautions**

Commissions inevitably come with potential conflicts of interest. A commission-based advisor, for example, might be motivated to earn income by:

- Recommending mutual funds with sales charges (loads) when equivalent funds that don't pay sales charges to advisors (no-load funds) are available.
- Encouraging frequent buying and selling of securities to generate commissions, even though a buy-and-hold approach is usually in an investor's long-term interest.
- Recommending specific investment or insurance products over others primarily because of commission levels.

### **Fees versus Commissions: Advantages**

Fee-only advisors are almost always preferable to commission-based advisors. Don't be thrown off by charges that seem so visible—and perhaps appear high at first glance.

- The services of a fee-only advisor may actually be less expensive than "free" services when you compare the fees with the commissions you would pay on investments recommended by a commission-based adviser.
- A fee-only advisor's investment recommendations are not influenced by compensation arrangements. The advisor has no incentive to encourage frequent trading of securities, for example, or to favor load funds over no-load funds.
- Fee-only advisors typically provide clients with a wider variety of choices because recommendations aren't limited to firms offering attractive commissions on their investment products.

### **A Closer Look at Certain Commissions**

As with fees, you should look closely at commissions charged for products you would purchase through the advisor. This is especially true for investments because their costs directly reduce returns that end up in your pocket. Because mutual funds are so widely held, we illustrate the point in the following examples of fund investments.

- **Up-front commissions.** A typical initial sales charge for a load mutual fund is about 4%, or \$4,000 per \$100,000 invested. This means, for example, that only \$96,000 of \$100,000 earmarked for a load mutual fund would be put to work for you.
- **12b-1 fees.** All mutual funds have operating expenses, but the expense ratios of some funds are higher than others—and one reason may be that marketing (or 12b-1) fees are included in operating expenses. A portion of these fees may be used to pay commissions to financial advisors. The average expense ratio for funds that charge a 12b-1 fee is 1.21% (or \$1,210 per \$100,000), compared with 0.62% (\$620 per \$100,000) for funds without these fees. (All mutual fund industry data provided by Lipper Inc. unless otherwise noted.)
- **Different share classes.** Because most investors hate to pay up-front sales charges, many fund families now offer different classes of shares within a fund. Investors can choose a class that carries an up-front sales charge that reduces the amount initially invested. Or, investors can choose to invest the full amount and pay a higher annual expense ratio that is designed to provide commissions to the advisor year after year.

Of course, many advisors recommend no-load funds—such as Vanguard's—that have low expense ratios and no 12b-1 fees. This choice allows you to keep more of a fund's returns. Indeed, the combined cost of the advisor's fee and a low-cost fund's operating expenses could quite easily be lower than the ongoing operating costs of the average mutual fund alone. So keep no-load and low-cost funds in mind as you discuss investment options with your advisor.