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How to Evaluate Your Financial Adviser

The most-common way is to compare a portfolio against a popular index like the S&P 500. It also may be the worst way.

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As year-end approaches and investors start assessing how their financial advisers fared, many will turn to a familiar index or two—say, the Dow Jones Industrial Average or the S&P 500—and measure their portfolio's performance against it.

Big mistake, financial pros say.

While such indexes are popular yardsticks because they offer something of a snapshot of the market as a whole, they aren't necessarily appropriate benchmarks for measuring the performance of an individual portfolio. That's because most people own a range of investments beyond stocks—think bonds, alternatives and good old cash—to guard against risk. Even for those invested mainly in stocks, the Dow industrials and the S&P 500 may not be good measures because they are dominated by large U.S. companies, and advisers often put clients in foreign stocks and smaller U.S. firms with the potential to grow.

"There is no single benchmark that one can use to measure performance," says Jeremy Wilson, a certified financial planner and manager at Draffin & Tucker, an Atlanta advisory firm.

So what's the best way for investors to evaluate their advisers—or even themselves if they are managing their own money? Here are a few tips:

Find the right benchmark: For every sector of stocks—or every type of investment—there is likely to be an index that can serve as an appropriate measuring tool. Indeed, advisers often provide these indexes on quarterly reports so that clients can see how they're faring with any portion of their portfolio. Among the many indexes that are frequently used: MSCI EAFE (a Morgan Stanley index that tracks international markets in developed countries), Russell 2000 (a U.S. small-cap index) and the Barclays U.S. Aggregate Bond Index (for fixed income). There are indexes even for the most niche-oriented of investments. Investing in rare bottles of single-malt Scotch? There's the IGS (Investment Grade Scotch) index from Whisky Highland, a Scottish firm that tracks that market.

To be sure, sometimes a traditional index like the S&P 500 is worth using. "If there is a large cap portion of the portfolio, we'd use the S&P 500" as a benchmark, says Stephen Tuckwood, a wealth manager at United Capital in Atlanta. (Many experts warn against using the Dow industrials. They say it isn't as meaningful a measure of the broader market since it is comprised of only 30 stocks.)

Go the blended route: It is one thing to benchmark a portion of the portfolio. But given that most investors are likely to have a mix of stocks and bonds, how does that translate into a true benchmark? In short, it doesn't. That is why many advisers provide a blended benchmark—one that combines individual indexes into a meaningful whole. Often, these indexes are custom-designed for clients; or, they can be as simple as showing a client what a typical 60/40 portfolio would look like—meaning 60% stocks (based on a common stock index) and 40% bonds (based on a common bond index). Or it can be an 80/20 blend. (It can also be a blend of more than two indexes.) The important thing is that investors go by a blend that is "relevant to their situation," says Leslie D. Thompson of Spectrum Management Group, an advisory firm in Indianapolis. Advisers typically rely on in-house tools and programs to do the math, but they say the calculations can be done by clients with a simple spreadsheet program or even by hand.

Use Consistent Measures: Be wary of advisers who suggest you change your benchmark midstream because it could mean they're looking to hide their poor performance, pros say. Unless there has been a significant, permanent shift in the makeup of a portfolio, it does an investor little good to suddenly track a different benchmark. "A benchmark should be established at the beginning of the [advisory] relationship and shouldn't change," says Jon Smith, chief executive officer of DT Investment Partners, an advisory firm in Chadds Ford, Pa.

Consider other yardsticks: While indexes may be useful for measuring basic performance, pros say they don't really get to the key question for investors: Is their portfolio performing in a way that will allow them to meet their goals, be it paying for a child's education or funding their retirement? To that end, many advisers establish a target for the portfolio—say, 6% average annual returns over a set period—and consider that the true "benchmark." Some advisers have gone so far as to abandon the index-based benchmarks altogether when discussing performance with clients. "It is a lose-lose conversation," says Edward Kohlhepp, an independent adviser in Doylestown, Pa. When the market is up, he says, clients will want to know why their portfolios aren't faring as well as the S&P 500, even if their holdings incorporate more than just stocks. Conversely, when the market is down, they'll want to know why their portfolios aren't faring as well as, say, CD rates, even if only a portion of their investments is in cash. As an alternative to benchmarking, Mr. Kohlhepp often asks clients this: "Are you on track to retire on schedule?" (If they're already retired he might ask: "Do you have enough money for the rest of your life?")

Factor in the fees: If an adviser beats the benchmark by 1% but charges a 2% management fee, the result doesn't quite equate to a win. So, it is important for investors to know their true costs—or better yet, to have their adviser break it down. Many advisers do this as a matter of course, but it never hurts to ask.

look at the big picture: Many advisers provide a range of services—from helping clients find a mortgage to helping them create a lifelong financial plan—that go beyond investing.

As such, it may not make sense to judge advisers solely on whether they can beat an index. Rather, "it is a piece of the evaluation," says Jason Lina of Resource Planning Group, an Atlanta advisory firm. And that isn't factoring in the intangibles: Is the adviser quick to respond to a question? Can the adviser refer you to a good accountant or estate attorney? Such things aren't easily "benchmarked" and yet they may be what matters most in the long run, pros say.