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New Ways to Weigh an Adviser

By JASON ZWEIG

How good is your financial adviser, anyway? Chances are, nobody—including your adviser—knows for sure.

That is starting to change, but getting better measures of advisers' performance isn't going to be easy.


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Two companies—BrightScope, a San Diego-based financial-research firm, and Spaulding Group of Somerset, N.J., which specializes in measuring investment performance—recently announced a joint proposal to standardize how stockbrokers and planners report their returns to prospective and existing clients.

The CFA Institute, a nonprofit association of financial analysts, also is working on new standards for presenting returns to retail clients, says an executive director there, Jonathan Boersma.

Most large investment-advisory firms comply with strict rules on performance reporting set by the CFA Institute. But so far at least, at small advisory firms—as well as at large brokerages—performance reporting remains a Tower of Babel. Under the law, advisers can't lie or mislead about their returns, but otherwise, says David Spaulding of Spaulding Group, "there are no rules."

As a result, one firm might show you the performance of a "representative" portfolio, or a single account chosen for specific attributes. (It isn't likely to be a stinker.) Another could show you a "model" or hypothetical portfolio. (It might not have existed for the full period and might not reflect fees and trading costs.) You might see decades of "back-tested" returns for the firm's favorite strategy. (But you might not be told the firm has been using it for only a year; nor will you necessarily see the failed strategies the firm used in prior years.)

Without clear information on returns, you don't have all the evidence you need to select—or keep—an adviser. There isn't any doubt that some advisers can pick superior investments. Even those who aren't particularly good at it might still be better at it than their clients. But there also is plenty of evidence that many advisers are poor performers.

A new study from Cerulli Associates, a financial-research firm in Boston, looks at prepackaged "mutual-fund advisory programs." Here, brokerage firms or banks wrap funds together into bundles, which advisers can then choose among for their clients. Cerulli compared how these prefab fund baskets fared against portfolios built by advisers who were free to move money around as they wished.

Over the past two years, estimates Cerulli, the fund portfolios that advisers tinkered with at will gained an annual average of 2.1%; the packaged portfolios returned 4.8% annually; and a blended benchmark of stocks and bonds grew at 7.7% annually.

In down markets, "advisers are going to cash and saving their clients money," says Scott Smith, an analyst at Cerulli. "But then they're getting blown away because they don't get back in fast enough."

Another recent study analyzed the retirement portfolios of investors in Oregon who could choose either to manage their own accounts or to hire a financial adviser. Between 1999 and 2009, those who worked with a broker underperformed those who ran their own money by an average of 1.5 percentage points annually. Fees accounted for only about half the gap.

So if you want to work with an adviser, it is important to establish that you aren't getting one whose returns will stink up the joint.

"Any industry that achieves high credibility across society has consistent standards for reporting outcomes so that a third party can judge whether you're doing a good job or not," says Mike Alfred, chief executive of BrightScope.

The new standards proposed by BrightScope and Spaulding, however, don't prohibit advisers from using representative, model or backtested portfolios. Mr. Spaulding says those approaches are "not something we would recommend" and that they may well be eliminated or restricted as the proposed standards evolve.

Adds Mr. Spaulding: "We want to ensure that if an adviser says, 'I'm really good at this and I can prove it to you,' we have a consistent standard that defines the rules of disclosure so the information is presented in an appropriate manner."

People familiar with the industry, however, point out that many advisers are too new to the business to have a track record, while the marketing pitch of veterans is being tainted by the lousy returns of the markets in the past decade. Thus it could be hard to get brokerage firms to sign on to a new standard unless their advisers are permitted to use models, back-tested portfolios and other such statistical monkeyshines.

Of course, you may value your adviser for more than his knack of picking stocks or funds. He might keep you from panicking during a financial crisis or from joining the stampede in a bull market, or might be an expert at tax or estate planning. Those factors are valuable, although they can't always be measured.

Portfolio returns, on the other hand, can be measured. Ask advisers how often they trade and why; anything more than a handful of trades a year is likely to lower your returns and sure to raise your taxes. Look for at least five years of data, and ask for account results from September 2008 through March 2009 to see how the adviser steered through a market panic.

Until a suitable yardstick is perfected, investors should steer clear of advisers who can't point to the real returns of actual clients. The markets are tough enough without having to guess your adviser's results.

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