What Is A Fiduciary?

What is a fiduciary? It is a word that is thrown around a lot. A fiduciary is an advocate for their clients and acts in the best interest of the client at all times.

While advisors who work at a brokerage firm may attempt to act as a fiduciary and make decisions for the clients' best interest, the very nature of working for a big brokerage firm often makes it impossible for them to do so.

What are the specific differences between those who can serve as a "true" fiduciary and those who cannot? Here are five key characteristics to consider:

1. Putting the Client First

Advisors at brokerage firms serve as "product advocates" for their firm, limited to the technology, products and platform approved by their firms. Whereas independent advisors serve as "client advocates," where the advisor looks for the best solution to serve their clients' needs.

Example: At a brokerage firm, clients can be forced to use the bank's money market fund. Because there is no competition, these money market funds typically pay much lower interest rates than other 3rd party money market funds. Why? This is a very profitable strategy for the bank. Independent advisors have the ability to "shop" for the highest yielding money market fund to increase the yield on a client's cash balance.

2. Transparency, Transparency, Transparency

With an independent firm, the cost structure is simple and transparent. At a brokerage firm, there can be many different ways that the advisor makes money… whether that be commissions, fees from investment products, cross selling other services, misc. charges or something else. Independence facilitates transparency and improves the service model and the client's ability to understand what they are paying.

Example: Knick-knack fees. Everyone hates them. Brokerage firms are becoming more comfortable charging knick-knack fees as a "backdoor" way of increasing revenue. An independent advisor has the ability to avoid them completely or absorb the cost for the client. The independent cost structure within the independent space is more simple and straightforward.

3. Unbiased Advice

Unlike the brokerage firms, independent advisors who are providing advice through a Registered Investment Advisor (RIA) are not paid by 3rd party investment companies. Their compensation structure is more transparent. The best interest of the client is better aligned with the advisor in the independent space.

Example: There are two equity mutual funds. Fund #1 has more risk and a lower historic return compared to Fund #2. Based on research, it appears that Fund #2 is the better investment for the client. However, Fund #1 pays the advisor more than Fund #2 by means of a commission paid directly from the mutual fund company. At a brokerage firm, the advisor would have to choose between these two options. An independent advisor who is giving advice through a RIA does not have this conflict of interest because he/she is not compensated by 3rd party investment companies.

4. Cookie Cutter vs. Custom

Large brokerage firms are now forced to manage to the lowest common denominator. Because of this, many advisors at brokerage firms are “encouraged” to have their clients invest in a pre-built cookie-cutter portfolio. While this might not be what is best for the client, it provides efficiency and scale. Independent firms are smaller and more nimble. Because of this, they have more flexibility to build custom portfolios which suit the needs of the client.

Example: Many brokerage firms have advisors label their client as “conservative”, “moderate”, or “growth”. They have to fit into one of these boxes. What if a client needs to have extra cash held for a future tax payment? What if a client feels more comfortable with dividend paying stocks than the predetermined stock mix of the portfolio? What if a client is not comfortable with an allocation to international equities? An independent advisor has the ability to build a custom portfolio to suit the client’s needs.

5. The Cross Selling Conundrum

Many brokerage firms have “encouraged” advisors to have clients utilize other services of the bank and/or brokerage firm. This puts the advisor is an uncomfortable position because they could possibly receive a bonus based on successfully “selling” another bank service to a client. Or the brokerage firm might reduce the advisors compensation if they do not sell other bank products.

Example: A brokerage firm advisor could be encouraged to open at least 5 lines of credit for clients this year. If he is successful, there will be a bonus for him at the end of the year. An independent advisor has no one telling him/her what to do with clients. They are attempting to do what is best for clients at all times. If a line of credit is needed, an independent advisor has access to that service but has no reason to “push” that service on a client.

A Stark Contrast

While there are good men and women who care for clients while working at a brokerage firm, they are unable to be a “true” fiduciary. Ultimately, a fiduciary always operates with the clients’ best interest by striving to eliminate conflicts of interest.

Is your advisor a fiduciary?

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