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Safeguarding Your Assets from Today's Top Wealth Management Pitfalls

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Over the last nine years, SpringReef has had the pleasure of assisting over 160 high net worth families and nonprofit organizations, with cumulative investment assets of over $12.5 billion, in the evaluation and selection of investment advisory providers. This has allowed us the unique opportunity to review countless investment portfolios and perform due diligence on hundreds of financial advisors and wealth management firms. It has also provided us with an unparaleled insider's view into an industry frequently characterized by its widespread lack of transparency.

What have we uncovered over the course of our work?

On the positive side, we've found that excellent financial advisors exist within each of the primary wealth management models – brokerage firms, private banks, trust companies, and registered investment advisers (RIAs) – and that they wake up each day looking to do everything possible to place their clients' best interests first, regardless of whether they're working under the suitability or fiduciary standard.

We've also come across best-in-class wealth management organizations with comprehensive, thoughtful, and innovative investment processes and capabilities, and with unconflicted fee structures that aim to give clients the best chance possible for positive investment results.

Unfortunately, we've also seen the less pleasant side of the industry, one where clients' best interests don't necessarily come first, where conflicts of interest negatively influence results, and where an overall lack of transparency often places clients in a precarious financial position.

While we could fill an entire book with the bad behavior, unethical practices, and incompetent advice we've seen and heard, if we were to summarize the most prevalent and pressing issues across the industry today – those that have a direct impact on clients and the safety of their assets – they would come down to the following:

- Issue 1: **A Client-and-Advisor Mismatch**
- Issue 2: **Inadequate Performance Reporting**
- Issue 3: **Firm- and Advisor-Level Fee Conflicts**
- Issue 4: **Oversized Managers with High Total Fees and Poor Performance**

In the content that follows, you'll find a summary of each issue, along with our thoughts on how to mitigate these challenges in your own wealth management relationships. While this is by no means an extensive list of everything that could go wrong with a financial advisor, being aware of and solving for these specific challenges should provide you with a much stronger foundation upon which to build your family's wealth.

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Issue 1: A Client-and-Advisor Mismatch

All too often, clients are poorly matched with their wealth management providers, and as a result, find themselves in a relationship that has little chance of being successful or satisfying.

The issue often begins in the early stages of the wealth manager selection process. Even though every family is unique in its circumstances, they often select an advisor based on the recommendation of a lawyer, accountant, family member or colleague, or sometimes simply on firm name recognition, and move forward without fully determining whether the provider is the best match for their specific needs. In short, they end up choosing who they perceive to be the best advisor amongst the several to which they've been referred, as opposed to the best fit within the broader advisor landscape.

The truth is that every advisor and wealth management firm is different, and while some of these differences are large and obvious, more frequently, they are nuanced and less visible to the untrained eye. Providers vary on many dimensions – among them size and scale, investment strategy, tactical views, investment solution preferences, fees, conflicts of interest, performance reporting, and client service – and what works well for one family may not align well with the needs of another.

To make things more complicated, given that wealth management is a highly sales-centric business, advisors are skilled at minimizing apparent disconnects between their capabilities and a client's needs. After all, advisors ultimately get paid based on client assets, and given the opportunity to work with a wealthy family, most won't hesitate to say they'd be the perfect fit, even though only a small percentage are truly focused on, experienced in, and sufficiently skilled at serving families of significant wealth.

All of this can result in a critical disconnect between a family and its chosen advisor, one that can have a significant impact on the family's long-term financial security, stability, and satisfaction.

The Solution: Whether you're already working with a financial advisor or are in the process of finding one, it's always a good idea to assess the provider's alignment with your circumstances, preferences, needs, and goals. The five guidelines below are a great place to start:

1. Thin the herd by making some broad structural decisions based on what's important to your family:
   - Do you want a large national firm or a more private wealth-focused boutique?
   - Do you prefer the brokerage model (transaction-based and suitability-oriented), the advisory model (fee-based and fiduciary-oriented), or a hybrid of the two?
   - Would you like a firm-controlled or an advisor-controlled investment strategy and investment solution set?
   - Would you prefer a firm that utilizes proprietary products or focuses solely on 3rd-party managers?
2. Ensure that both the firm and advisor's mean and median client size matches your circumstances, and ask them to divulge how many of their clients are like your family in terms of asset size and complexity;
3. Make sure the advisor and firm have sufficient resources dedicated to and expertise in the types of investment solutions you're likely to employ (e.g. separate accounts, hedge funds, private investments, etc.);
4. For those families currently going through the provider search process, require a prospective firm to provide you with a representative record of historical client performance, and to demonstrate how it has added value to its clients' investment results over time;
5. Review the regulatory records of your advisor and firm on the SEC and FINRA websites and question your advisor if you see anything concerning.

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Issue 2: Inadequate Performance Reporting

One of the distinguishing characteristics of a quality wealth manager is the ability to clearly articulate how a client's portfolio has performed over time – net-of-fees and against relevant benchmarks. Unfortunately, our experience has shown that many firms are unable, or perhaps unwilling, to provide this basic yet critical information. This means that, all too often, the data that clients receive provides an inaccurate or incomplete picture of their investment performance results.

The Solution: You should never have to settle for opaque performance reporting, and based on our experience, there are several ways that you can increase the transparency of the data you receive.

Most investment portfolios are designed to produce an expected long-term return based on a combination of a family's unique circumstances, a strategic asset allocation informed by the advisor's capital market assumptions, and the client's tolerance for volatility and risk. This long-term return expectation can be as simple as a specific percentage or a percentage plus inflation. For a client to be fully informed of how a portfolio has performed, an advisor should provide the following four sets of data:

1. **Performance vs. the Long-Term Return Expectation:** Net-of-fee portfolio return vs. the long-term return goal of the portfolio;
2. **Performance vs. the Strategic Policy Benchmark:** Net-of-fee portfolio return vs. a benchmark comprised of asset class indices and proportionately weighted according to the portfolio's policy allocation;
3. **Performance vs. Manager Benchmarks:** Performance of each investment solution or manager vs. the appropriate asset class benchmark. This is an important part of understanding the underlying cause of a portfolio's performance – by asset-weighting these differentials, one can assess the skill of the advisor in selecting managers that outperform their respective benchmarks;
4. **Performance of the Strategic Policy Benchmark vs. the Tactical Policy Benchmark:** Performance of the actual asset allocation for the period vs. the long-term strategic benchmark (proportionately-weighted asset class indices should be employed). Many firms offer tactical asset allocation advice in an attempt to enhance returns relative to the strategic allocation, and this comparison will measure whether these tactical shifts added to or detracted from the strategic asset allocation.

Issue 3 *(2-Part)*: Firm- and Advisor-Level Fee Conflicts

Firm-Level Fee Conflicts: Within many wealth management organizations, revenue-sharing and retrocessions can have a significant impact on the investments that end up in a client's portfolio. Asset managers often pay firms to have their products made available to clients, as well as for access to the firm's offices or for various types of sales data. These fees can easily total millions of dollars. Unfortunately, the managers who pay these fees are more likely to end up in a client's portfolio, and the managers who don't can be excluded from a firm's product platform altogether.

The Solution: Ask your advisor to disclose all revenue-sharing and retrocession payments related to each of the asset managers employed in your portfolio. Additionally, double-check to make sure that each of the managers is consistent with your long-term investment strategy and has outperformed peers over an appropriate period (e.g. five years). Finally, be wary of new products with no proven track record, especially when offered by managers who compensate the firm.

Advisor-Level Fee Conflicts: Within many wealth management firms, advisory fees and commissions can vary significantly based on the asset class or investment solutions in a client's portfolio – for example, the fees might be different for fixed income, equities, and for alternative investments. They might also differ depending on whether a solution is proprietary or managed by a 3rd-party. Unfortunately, this pricing scheme introduces a material conflict of interest into a

client relationship, since the firm and advisor may have a financial interest in directing client assets to more lucrative asset classes or solutions.

The Solution: The cleanest solution is to select a wealth management firm that offers a fixed or asset-based advisory fee, regardless of your asset allocation or the investment solutions in your portfolio. Alternatively, should you find yourself working with a firm with this embedded conflict, require that your advisor disclose the firm's advisory fee or commission, the 3rd-party management fee or expense ratio, and the total fee for each of your investment solutions. After ensuring that each investment and the overall asset allocation is consistent with your long-term investment strategy, make sure that the allocation to more lucrative solutions doesn't drift higher over time, and that your advisor can demonstrate that the added expense is justified by the risk-adjusted after-fee returns.

Issue 4: Oversized Managers with High Total Fees and Poor Performance

As many quality financial advisors will attest, assets can be the enemy of returns. But how exactly does this impact your portfolio, and what does it mean for your investment returns?

As part of their investment offering, many large wealth management firms offer their clients a roster of 3rd-party investment managers. Unfortunately, with thousands of advisors and millions of clients to serve, the managers they often recommend are those that have made a strategic decision to scale their operations – in other words, they've chosen to accept substantially more client assets at lower fees, and in many cases, they make their strategies available to not just one, but to multiple wealth management organizations.

How does this end up affecting the client? With so many dollars chasing so few great ideas, many of these managers' portfolios begin to perform like their benchmarks – or worse. Add in a manager's fees and the wealth management firm's advisory fee, and the totals can easily exceed 2%. As a result, clients can end up with performance that is substantially below benchmark.

We've found only one large wealth management firm that has been able to demonstrate that the active managers it offers have outperformed peers and benchmarks. With this one exception, our experience has shown that clients of most large firms are likely to experience below-benchmark and lower-quartile performance for active management on managed account platforms.

The Solution: Determine if your advisor is offering you a best-in-class boutique manager by asking the following:

1. What are the total assets under management with this particular strategy?
2. Does the manager have any of their personal capital invested in the strategy?
3. How many other wealth management firms offer this strategy?
4. How much of the total fee goes to the manager, and how much does the firm keep?
5. Has the manager's performance ranked in the top-third of its peer group over the last three and five years?

Alternatively, you can consider passive solutions (e.g. ETFs and index funds) in a brokerage account and get index-like performance, avoid an advisory fee, and enjoy the benefits of their tax efficiency.

Conclusion:

If you're currently in an established wealth management relationship, regardless of your level of satisfaction, it never hurts to take a peek under the hood and make sure everything is in order. After all, you've entrusted the safety of your family's financial future to your advisor, and you deserve to know that you're in good hands. By addressing the four issues we've

outlined here, we believe you and your family will have a higher chance of securing your financial wellbeing and achieving your overall goals.

For those of you currently searching for a new financial advisor, you should, first and foremost, focus on establishing and adhering to a rigorous search process – from our experience, this is a critical step towards achieving an optimal outcome. During your search, however, be sure to consider the issues we've noted here, and you'll greatly improve your chances for a successful and rewarding wealth management relationship.

SpringReef LLC is an investor advocate, providing independent, unbiased guidance to high net worth families and nonprofit organizations on critical aspects of wealth management. We offer comprehensive financial advisor evaluations, including assessments of investment performance, investment solutions, and fees, along with searches for best-in-class financial advisors and ongoing advisor monitoring and coordination.

For more information, please contact us at (973) 577-3184 or at info@springreef.com, or visit us at www.springreef.com.

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