

FINANCIAL ADVICE

Does it Make a Difference?



Presented by:

Michael S. Finke, Ph.D., CFP®

Associate Professor & Ph.D. Program Director

Department of Personal Financial Planning

TEXAS TECH UNIVERSITY



Increasing Responsibility with Limited Ability: The Consumer Problem



A young investor willing to take moderate risk for above-average growth would be most interested in:

- A. Treasury bills
- B. Money market mutual funds
- C. Balanced stock funds

A?	8%
B?	42%
C?	38%
Don't know?	12%

Tax Knowledge



To ensure that some of your retirement savings will not be subject to income tax upon withdrawal, you would contribute to a:

A. Traditional IRA

B. Roth IRA

C. 401(k) plan

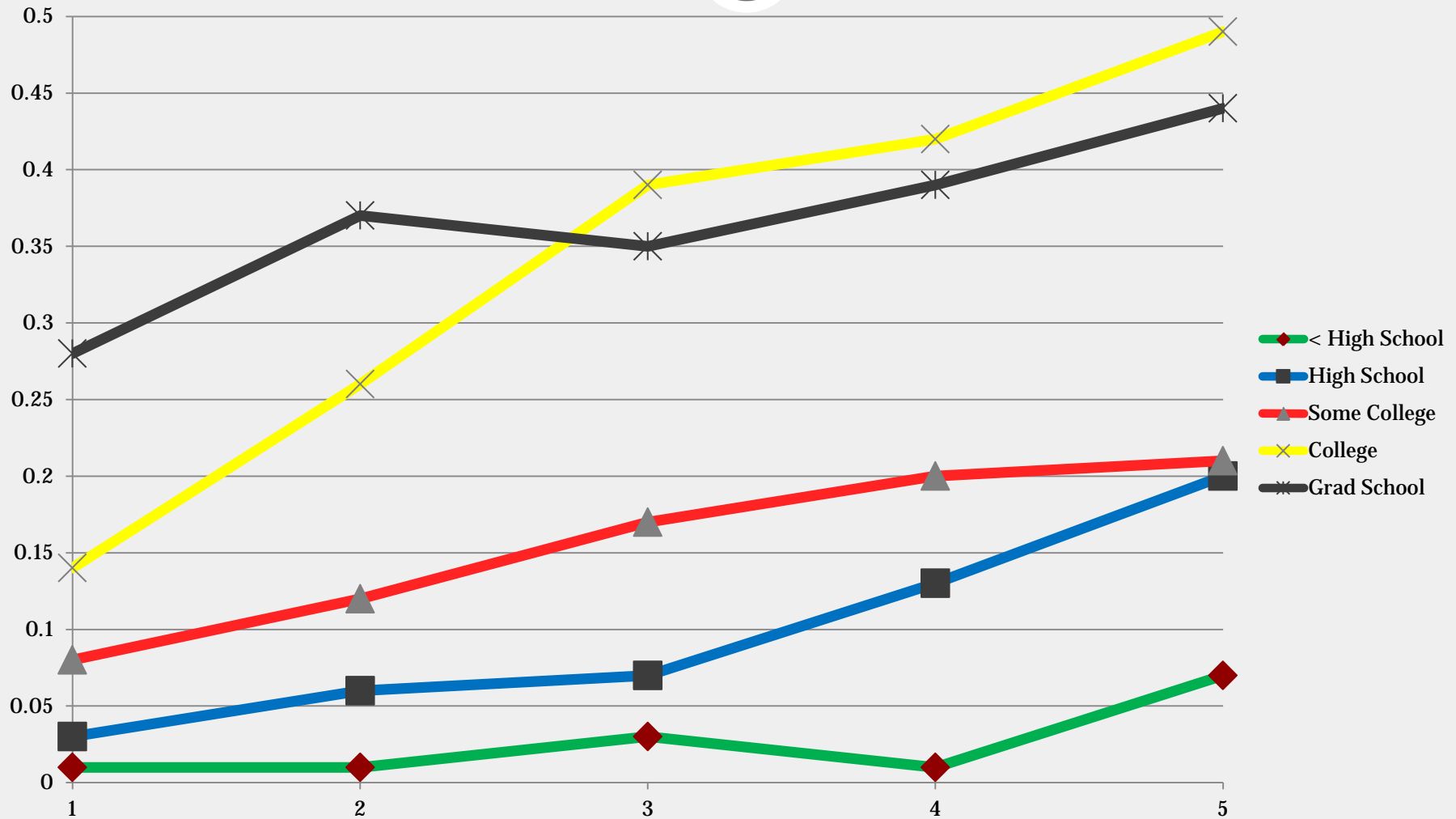
A? **14%**

B? **38%**

C? **36%**

Don't know? **12%**

Roth Ownership by Education and IQ Quintile



(Source: Cummings, Finke and James, 2011)

The Solution?



- **Hire a financial advice professional**
 - Need a will? Hire an attorney
 - Need a retirement plan? Hire a financial adviser
- **Adviser makes costly investment in household finance**
 - Household pays for knowledge
- **Theoretical benefit**
 - Expected life happiness with a professional financial plan >
 - Doing it yourself

Benefits/Costs of Advice



Increase in expected
consumption



Expected Fees
Paid to Advisor

Who Uses a Financial Planner?



Wealth Quintile	Consulted a Financial Planner	Calculated Retirement Needs	Used a Computer Program	Read Magazines or Books
Lowest	5.4%	10.8%	3.6%	15.8%
Quintile 2	7.1%	14.4%	5.5%	21.3%
Quintile 3	12.0%	19.8%	8.8%	28.9%
Quintile 4	22.8%	29.6%	14.5%	38.1%
Highest	38.2%	46.1%	29.5%	54.4%

(Source: Martin and Finke, 2012)

Do the Rich Seek Professional Advice?



- **Demand:**
 - Greater wealth, greater expected benefit from better decisions
- **Supply:**
 - Vast majority of adviser compensation increases with investible assets
 - Commissions, fees among brokers increase with assets

Empirical Evidence

(Bhattacharya, Hackethal, Kaesler, Loos and Meyer, 2011)



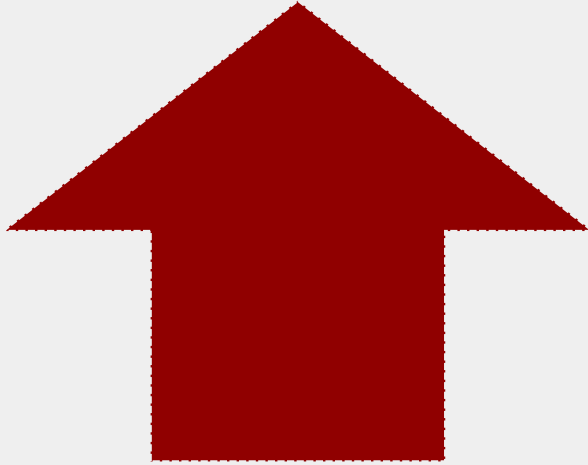
- **8,000 bank customers in Germany**
 - Offered no cost, high quality independent financial advice
 - Only 5% accepted the free advice
- **More likely to accept financial advice?**
 - Wealthy, men, older, less behavioral
- **Explanations**
 - Fixed time cost of getting advice (makes sense for wealthy)
 - More sophisticated may recognize benefits from advice

Does an adviser improve investment performance?



- Evidence:
 - Portfolios more diversified, but pay higher fees
 - ✦ *Bluethgen, Gintschel, Hackethal & Mueller, 2008*
 - Better diversified, but no evidence of better performance
 - ✦ Kramer, 2011
 - Higher turnover leads to lower net performance
 - ✦ *Hackethal, Haliassos & Jappelli, 2011*
- All use commission-compensated advisers
- Are results surprising?

The Investment Advice Tradeoff



Improved Investment Quality

- Greater diversification
- More appropriate risk allocation
- Tax efficiency



Reduced Performance

- Fee and commission drag
- Commissions = \uparrow turnover

Sentiment Trading



- **Fund investors underperform by 1.56% per year**
 - ✦ *Friesen & Sapp (2008)*
 - Mainly from selling equities in bear markets (15bp/month)
 - 233% increase in DC who sold 100% of equities during 2007/2008 recession (*Mottola & Utkus, 2009*)
- **Can a financial planner help you stay the course?**
- **Who didn't rebalance into cash in great recession?**
 - *Winchester, Huston, & Finke (2011)*
- **Strongest predictor is those who use a comprehensive planner with a written plan**
- **Advisers tend to be less behavioral** (*Shapira & Venezia, 2001*)

Commissions and Sentiment



- Commissions increase incentive to recommend trades
- Encourage clients to chase returns
 - Instead of de-biasing them by talking them down
- Funds bought through broker channel underperform no-loads by 1.5%/year *(Bullard, Friesen & Sapp, 2008)*
 - Primarily due to bad investor timing
 - (buy more in a bull market, sell in a bear)
- De-biasing valuable to clients, but advisers won't do it if it hurts their compensation *(Anagol, Cole & Sarkar, 2012)*

Advice and Retirement Saving



- Households between 43-50
- What is the impact of using a financial planner on:
 - Net worth
 - Total savings in sheltered retirement accounts
 - Owning an IRA or Keogh
 - Having calculated how much need to save for retirement
- Strong positive impact on net worth and retirement savings (controlling for income earned in prior 14 years)
- 115% more likely to own an IRA
- 5 times more likely to have calculated retirement needs

Retirement Savings Difference



Compared to those who had:

- No Planner and
- No Needs Calculated

Controlling for income and other demographic variables

Agency Costs



- Client knows less than adviser (agent)
- Hires adviser to make recommendations
- But they are 2 people, each looking out for themselves
- Imbalance of information creates opportunities to make recommendations not in best interest of client

Commission Compensation



- Opaque – consumers don't know what they pay
- Evidence that opaque pricing splits consumer in 2
 - Sophisticated recognize shrouded pricing
 - Naïve consumers don't and end up paying more
- Direct channel versus broker-sold performance
- Insurance recommendations
- Tolls and the problem of non-salient pricing
- Many clients don't know how their adviser is paid

Fee Compensation



- Adviser motivated to increase client assets (aligned interest)
- Incentive to maintain long-run relationship
- & provide advice beyond commission products
- Example:
 - Households who use a financial planner far more likely to have adequate life insurance than those who use a broker
 - ✦ *Finke, Huston & Waller, 2009*

But Aren't Perfect



- Incentive to liquidate assets that don't provide fees
- Less likely to recommend annuitization
- Disincentive to reduce debt
- Surprisingly little evidence of price competition
- Asset fees less salient than hourly charges
 - Like income tax versus property tax (*Cabral & Hoxby, 2011*)

Improving the Market for Advice



- Reduce confusion about fiduciary standards
 - Finke & Langdon (2012) find minimal impact on brokers
- Restrict non-salient compensation
 - Improve disclosure
 - UK, Australia close to eliminating commissions
 - Some evidence that this may impact advice for less wealthy
 - Evidence that less sophisticated prefer shrouded pricing
- Making it a profession
 - Improving educational standards
 - Consistent, science-based body of knowledge
 - Reduce proliferation of certifications so quality signals credible



Questions/Comments



Michael S. Finke, Ph.D., CFP®

*Associate Professor & Ph.D. Program Director
Department of Personal Financial Planning*

TEXAS TECH UNIVERSITY

Michael.Finke@ttu.edu