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Cutting Through the Clutter! What Does It Mean For You?

In the first white paper of this series, we introduced a framework for wealthy families to use to cut through marketing clutter that makes different wealth management firms look and sound alike. We also introduced the fundamental differences between three main kinds of advisors: manufacturers and distributors (i.e., those firms which provide or sell financial products and services); and independent, fee-only fiduciaries (i.e., those firms that help families select and purchase a mix of products and services but also have a fiduciary obligation to place the clients' interests ahead of their own).

In this paper, we take a step further to help families differentiate between the various kinds of wealth management firms, and also to understand the practical implications of working with each of the three main types of advisors. Our objective is not to recommend one type over another, but rather to help families understand the business model and interests of each type so that their choice of which firm or firms to work with is an informed one.

// MANUFACTURER

Manufacturers create and sell financial products. Typical examples are investment funds like a mutual fund company, private equity firm, or hedge fund. Manufacturers sell to investors (clients), either directly, or through distributors, which are typically banks or brokerage firms.

Going Direct: Some families prefer to directly access Manufacturers, saving the added cost of using a distributor-intermediary such as a brokerage firm. Going "directly to the factory" and eliminating the middleman yields the benefit of not paying additional distribution fees and commissions to private banks and brokerage firms.

There are several challenges of working directly with Manufacturers.

1. Manufacturers offer little in the way of client service, so these families than face challenges sourcing and researching investment ideas from multiple Manufacturers.
2. Clients are responsible for viewing their investments across all manufacturers, reconciling and keeping track of multiple positions and countless transactions.
3. Clients also face the challenges of determining and maintaining optimal asset allocation and managing their portfolio's risk.

To address these challenges, some families identify family members who will play this role based on their education and experience, and/or establish their own family offices to handle these advisory and integration activities. However, the cost of doing so can be prohibitive: establishing a family office can cost in excess of $1 million per year.

Through A Distributor: Manufacturers may also be affiliated with financial services companies, which often act as Distributors for their products (for example, a broker-dealer). See description of working with a Distributor below.

// DISTRIBUTOR

Many ultra-high net worth families prefer to use traditional wealth management firms such as private banks, trust companies and brokerage firms. These Distributor firms typically provide their clients with wealth management advice and sell them investment products. Distributors often have arrangements in which they are paid commissions or fees by Manufacturers to distribute their products. Such distribution agreements often exclude other investment products from the distributor's menu of available investments. In many cases, the products or services recommended by a Distributor are from affiliated providers or manufacturers. In these cases, the family has to be sure it's getting the best products for its needs and goals. In addition, the family has to pay careful attention to the fees and commissions they are paying. Distributors often receive both transaction-based fees (including sales commissions) from their customers, and distribution fees from the Manufacturers whose products they sell.

Actual and potential conflicts of interest are often problematic in the traditional, distribution-focused wealth management space because a financial service firm will often sell products and services from providers in which it has a financial stake. In addition, certain Distributors, such as broker-dealers, are not legally bound to a **fiduciary standard** requiring that the advice, products and services they give their customers are in the customer's best interests. A Distributor's affiliations and compensation arrangements with its customers and Manufacturers often present numerous actual or potential conflicts of interest. It is these actual and potential conflicts that give rise to the extensive "small print" disclosures investors often face. In addition, depending on whether the Distributor has a fiduciary obligation to the investor, it may not be required to disclose certain conflicts in writing to investors.

Many families prefer “one stop shopping” using Distributors, and have formed long-standing relationships with individuals at these firms. This convenience is one of several advantages of using a Distributor, but families who engage a wealth management firm should ask their Distributors a few key questions (ideally in writing):

- **Does the advisor have a legal obligation to put my interests first – i.e., a fiduciary obligation?**
- **How is this firm/adviser compensated? Is it transaction or sales-based?**
- **Is the advisor’s firm affiliated with, or does it have, a distribution agreement with the manager or strategy the advisor is recommending to me?**
- **If a particular product or service is purchased, what compensation does each of (1) the advisor firm; and (2) the individual advisor earn, now and for the duration of my holding the investment?**
- **What other (lower cost) options might I have and what are the tradeoffs?**

When working with a Distributor-advisor, investors need to exercise caveat emptor and ask questions to make an assessment of whether their interests are being well served in the relationship or transaction. The potential problem arises when the investor assumes the advice provided by their adviser is in their best interests and free of any transaction-based financial benefit to the advisor when, in reality, neither may be the case.

The result is a lack of clarity that is potentially harmful to the client – possible examples include the sale of financial products that may be priced inappropriately, or discordant with the client’s ultimate objectives.

A potential solution to this challenge can be to hire an independent, fee-only fiduciary adviser to represent the family in its dealings with the financial institutions to ensure appropriate oversight and integration with the family’s objectives.

// INDEPENDENT FEE-ONLY FIDUCIARIES (IFOF)

Many ultra-high net worth families retain a fiduciary adviser not affiliated with any manufacturer or distributor to help them evaluate and select products and services from both manufacturers and distributors. These families have the benefit of not being restricted to certain Manufacturer’s or Distributor’s limited menus of investment products and ideas. In return, they pay the IFOF a fee for its services. These fees are generally significantly lower than the cost of establishing a stand-alone family office to play this role.

Based on the amount of advised assets or as a flat retainer, these fees are separate from manufacturers' and distributors' costs and fees. However, because IFOFs are often able to negotiate terms on the family's behalf, the total amount paid by the family may still be less than if they were to go through a distributor (such as a private bank).

Ideally, by hiring an IFOF, a wealthy family is able to design an overall approach to managing their wealth, gain access to a variety of products and services that are right for them, and reduce the fees and charges they pay their various providers. In addition, depending on the range and depth of an IFOF's personnel's expertise, most IFOF's can provide a broad range of wealth management services in addition to investment advice. Such additional services may include robust consolidated reporting, data reconciliation, family governance advice, financial planning, etc. These services can assist the family in making informed decisions about their portfolios and overall wealth management strategy which can quantitatively and qualitatively impact the family's wealth enterprise.

A few of the defining characteristics of an IFOF include:

- No potential or actual conflicts of interests caused by affiliations with Distributors or Manufacturers;
- Coordination and reconciliation across all investments, accounts and holdings;
- Advice that is legally required to be in the best interest of the client;
- Clients pay a set fee, typically based on the amounts of assets under advisement, or as a fixed retainer.

// SUMMARY

The definitions and descriptions of these three types of advisers are broad and within each category there are many variations. By looking at the fine print to evaluate an advisor firm's business model and its economic and institutional interests, a family can learn about any potential or actual conflicts that might prevent an advisor from providing advice in the family's best interests. In the next paper in this series, we take a more detailed look at the advisor space and examine in further detail how all "advisors" are not in fact the same.