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Financial Advice: Does it Make a Difference?

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Financial Advice: Does it Make a Difference?

Abstract

The financial advice profession provides a potentially valuable service to consumers within an increasingly complex financial marketplace. Financial advice professionals can substitute for costly investment in financial knowledge by households. This chapter provides evidence that financial advisers can improve financial outcomes when the interests of the advisor and household are aligned. Yet professional advice can harm consumers if conflicts of interest create high agency costs. Understanding how differences in compensation methods and regulatory frameworks affect incentives is essential to improving the breadth and quality of professional advice.

Keywords

Household finance, financial planning, financial advice, agency costs, fiduciary regulation, consumer economics

Disciplines

Economics

Comments

The published version of this Working Paper may be found in the 2013 publication: *The Market for Retirement Financial Advice*.

The Market for Retirement Financial Advice

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and Kent Smetters

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Chapter 11

Financial Advice: Does It Make a Difference?

Michael Finke

Households are faced with substantial responsibility for funding retirement through an increasingly complex mix of financial instruments. Making these difficult choices on their own requires investments in specific finance-related human capital that may be neither efficient for households nor for society. Given the large potential loss in welfare from poor financial decisions, renting the expertise of financial professionals may be even more useful than seeking the services of an attorney or an accountant.

Economics suggests that a household will hire a financial adviser if the expected increase in discounted lifetime utility from receiving professional advice exceeds the expected discounted cost of fees and expenses levied by the adviser. A rational household would recognize the benefit of hiring someone with financial expertise to develop a plan to invest in an efficient portfolio, make appropriate use of risk management products, distribute financial resources optimally across the life cycle, and develop a tax-minimizing bequest strategy.

Nevertheless, despite ample evidence of poor financial decisions by households, only about one in five relies on the advice of a financial professional in the United States (Elmerick et al., 2002). While it is remarkable that so few households are willing to pay for some financial help, it is also remarkable that so many households do hire a professional despite understanding little about the magnitude of the difference between informed and uninformed consumption, and often very little about how much it costs to receive the financial advice. Efforts to estimate the benefit of advice have not shown conclusively that consumers benefit from hiring a financial advisor (e.g., Hacketh and Inderst, 2013). This could be attributed to opaque and non-salient pricing of financial advising services and conflicts of interest within the industry.

Problems with pricing and the measurable benefit of financial advice may be traced to the emergence of the profession from a business that is primarily concerned with marketing financial products (Turner and Muir, 2013). The Securities Exchange Act of 1934 that regulates the conduct of broker-dealers assumes that the advice given by registered representatives is

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incidental to the sale of financial products. Customers (not clients) are assumed to seek out the services of a representative in order to facilitate the purchase of financial products such as a mutual fund or annuity. The representative recommends a product that falls within the bounds of suitability. Each party willingly participates in the transaction and presumably is made better off from trade. Unfortunately, one party (the customer) is at an informational disadvantage and may not even recognize that the advice is solely incidental to the sale of the financial product.

There are predictable costs that arise when consumers hire an agent to act on their behalf. As is well known, the principal and agent both seek to maximize their own welfare, which leads to a conflict when the interests of principal and agent are not aligned. Lusardi and Mitchell (2008) review a number of studies that document the low level of financial literacy in the United States. A principal (household) who knows little about financial markets will have difficulty assessing the quality of financial advice. This imbalance of financial knowledge between household and adviser thus can lead to difficulty assessing service quality before and even after purchase.

This chapter reviews the literature describing the value added from professional advice. The potential welfare gains from increased reliance on expert financial advice are significant, and there is some evidence that financial advisers help households make better financial decisions. Nevertheless, the results are generally mixed, and the outcomes may be worse when there are conflicts of interest resulting from adviser compensation incentives. In the absence of sound and consistent regulation of financial advisers, some households may be harmed by the use of an advisor who uses product pricing that is shrouded (not readily perceived by the consumer) and has informational advantages to extract wealth from clients. A lack of educational standards, reliable quality certifications, and consistent regulation to reduce conflicts of interest all prevent the financial advice profession from achieving the quality of other, similar advice professions.

Who receives professional financial advice?

Campbell (2006) documents numerous examples of household financial decision-making that are far from theoretically efficient (normatively optimal). Half of all households do not own equity, despite high historical returns and significantly reduced information and transaction costs. When they do invest in stocks, households tend to purchase more when stock prices are high and do not properly diversify their portfolios. Consumers also borrow at high interest rates while simultaneously holding liquid assets with little or no yield. Many do not refinance when they should and choose mortgage instruments that are inappropriate. Tax complexity leads to

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additional inefficient asset location outcomes. Few households annuitize at retirement despite obvious gains from mortality credits and protection against outliving assets. There is no doubt that household welfare could be improved through expert advice.

Wealth is far and away the strongest predictor of using a financial planner, followed by high income, a college degree, and self-employment (Finke et al., 2011). Respondents indicate that the most common reason they chose a financial adviser was a major life event such as the receipt of an inheritance or the sale of a business (ICI, 2007). Nevertheless, financial advice is not solely demand-driven. Advisers market their services to clients who have the greatest investible wealth because most compensation models for financial advisers provide an incentive to target wealthy clients. One reason for this is because there are often fixed costs associated with locating new clients, meeting with them to assess their goals and establish trust, and developing initial financial plans or product strategies. Since both commission compensation and asset under management fees rise with investible wealth, advisors are likely to earn more per unit of effort with wealthier clients.

Conversely, since the receipt of financial advice involves significant fixed costs even when free—for example, the time spent meeting with the advisor as well as evaluating and implementing advice—households with lower wealth may estimate that the benefit from improved investing is not worth the indirect costs. When free independent expert investment advice was offered to 8,000 randomly selected customers of a brokerage in Germany, only 5 percent of those were willing to accept it (Bhattacharya et al., 2012). Since the advice was offered at no cost to a random sample, preferences for receiving professional financial advice were free of supply bias. Higher wealth was strongly related to the probability of opting to receive financial advice. Greater financial sophistication among customers who accepted the financial advice suggests that those who anticipated gains from better informed financial decisions motivated the demand for professional advice.

The National Longitudinal Survey of Youth 1979 cohort asked respondents whether they consulted a financial planner when preparing for retirement. By the time of the 2008 survey, respondents were in their late 40s at the peak saving period of their life cycles. Table 11.1 shows the percentage of respondents by income, wealth, and cognitive ability quintiles, as well as by level of education and by respondent self-esteem (which may impact help-seeking behavior). Clearly, the use of a financial planner rises dramatically with wealth and income: nearly ten times the percentage of respondents in the top income and wealth quintile consulted a financial planner compared to the bottom income quintile. Only 10 percent of high school-educated respondents consulted a financial planner, more than one in

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TABLE 11.1 Household characteristics and retirement planning (%)

Household characteristics	Consulted a financial planner	Calculated retirement needs	Used a computer program	Read magazines or books
<i>Income</i>				
Lowest	4.0	10.2	2.5	14.1
Quintile 2	8.7	15.5	5.8	21.4
Quintile 3	15.5	24.4	11.9	32.6
Quintile 4	21.3	28.3	15.6	38.8
Highest	37.0	43.7	27.7	53.8
<i>Net worth</i>				
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
<i>Education</i>				
Less than high school	2.1	10.6	1.6	6.6
High school	10.2	17.1	6.3	21.7
Some college	18.5	25.1	13.5	37.6
College	33.4	41.5	25.6	51.3
Graduate	35.9	42.4	27.8	55.1
Renter	8.2	14.2	6.0	20.0
Homeowner	21.2	31.3	16.3	37.9
<i>Cognitive ability</i>				
Lowest	5.7	12.8	4.1	15.3
Quintile 2	11.5	17.1	7.4	25.7
Quintile 3	17.9	24.0	10.4	33.9
Quintile 4	21.7	31.6	15.8	39.3
Highest	34.1	39.7	27.3	50.7
<i>Self-esteem</i>				
Lowest	7.7	13.9	5.9	19.4
Quintile 2	15.7	22.6	11.9	29.8
Quintile 3	17.4	23.5	11.1	30.9
Quintile 4	20.1	29.0	15.3	36.8
Highest	25.7	31.9	17.5	41.0

Source: Author's computations from the National Longitudinal Survey of Youth (NLSY79) 2008 data.

three respondents with a college education did. Over one-third (34 percent) of respondents with the highest cognitive ability scores (measured as teenagers) used a financial planner, versus 6 percent of those in the lowest cognitive ability quintile. Respondents with higher self-esteem were also more likely to seek professional advice. In summary, those most likely to seek advice are not those who are most prone to make financial mistakes. Rather, they are most aware of the potential benefits from advice and have

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sufficient wealth to justify the psychic and time costs of seeing an adviser. People more likely to seek professional advice are also more likely to self-educate by seeking retirement-related information from books and computer programs.

The fact that professional financial advice is sought by households with more financial resources to manage is likely driven both by greater demand among the wealthy and by greater supply of planning services to them from advisers whose compensation increases with investible assets. These results provide evidence that financial sophistication increases demand for professional advice. The least sophisticated may have difficulty envisioning the benefit of seeking information or professional assistance without a clear understanding of the difference between their current and ideal financial situations.

Benefits from financial advice

Studies documenting the impact of financial advisers on household investment outcomes suffer, to some degree, from an inability to differentiate advisers according to their costs and ability to provide value. For instance, a study of German investors by Bluethgen et al. (2008) showed that investors who received advice had higher quality, more diversified portfolios, and also paid higher fees on their investments. It is possible that these fees provided compensation to the adviser for the benefits derived from improved investment efficiency. Kramer (2012) similarly found no evidence of portfolio performance differences between self-directed and professionally advised accounts, but did report that advised accounts were better diversified. Hackethal et al. (2011) indicated that German bank customers who used a commission-compensated financial adviser had lower performing portfolios net of costs, perhaps attributable to adviser incentives to increase turnover. Since many who used advisers had greater financial experience, the authors raised the possibility that advisers were like babysitters—they allowed otherwise high-quality ‘parents’ to buy a poorer-quality substitute for their costly time. It is also possible that advisors recommend more efficient investment choices that clients do not follow (Hackethal and Inderst, 2013).

Hung and Yoong (2013) reported that respondents who received unsolicited financial advice did not improve their investment behavior, while respondents who chose financial advice when it was optional did enhance their financial outcomes. The authors noted that offering financial advice as an employee benefit would help primarily the three-quarters of employees who indicated that they would use the advice if provided. It is possible that in order for advice to be effective, a client must be motivated to seek it

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out. This may also explain why the free advice provided to bank customers in Bhattacharya et al.'s study (2012) seemed to have little impact on financial performance.

Neuroscience theory has recently been used to help explain how the process of developing a financial plan can motivate a household to make welfare-maximizing decisions they otherwise would have avoided (James, 2011). Financial decisions made in the present can compromise long-run goals, because present thinking tends to be more emotional and less calculated. This occurs because rational, deliberate thinking occurs in the human cortex and we spend much of our daily lives using the emotional mammalian (limbic) brain. Reactions to risk or to the pain of resisting temptation are limbic responses that people attempt to control through cognitive effort. McClure et al. (2004) show through brain imaging that the limbic brain is primarily involved in short-run decisions, while long-run decision-making is conducted in the cortex. These findings can help explain why many households believe they should save more for retirement, but they are also unwilling to take time in the present to increase their contributions to their 401(k).

In such a setting, using a financial adviser has two benefits. One is that by simply sitting down, articulating goals, and developing a financial plan, a household is forced to apply a cooler, more rational decision-making process to help it make better decisions that involve intertemporal trade-offs. The second is that, by delegating some financial decisions to another person, such decisions are now distanced from the client's emotions. Emotions such as loss aversion are associated with limbic responses. If a client feels an emotional response to a market decline, an adviser can remind the client to focus on his long-term investment policy—allowing him to control emotions by literally providing a 'voice of reason.'

Loss aversion can also help explain why investors appear to do a poor job of market timing. Friesen and Sapp (2007) find that sentiment-driven flows into equity funds following an increase in equity valuations, and away from equity funds following a bear market, resulted in an annual underperformance of 1.56 percent per year. Withdrawals from equity funds were particularly harmful, causing an average loss of 15 basis points per month. There was a 233 percent increase in the number of defined contribution participants who sold 100 percent of their equity investments during the great recession of 2007 and 2008 (Mottola and Utkus, 2009). Winchester et al. (2011) used a survey that asked respondents receiving comprehensive advice (common among fee-based investment advisers) whether they shifted their portfolio toward cash during the financial crisis. A prudent adviser would have suggested either maintaining the current portfolio or rebalancing away from cash following an equity market decline. The authors found that the strongest predictor of not shifting into cash was

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whether the investor had a written financial plan. This suggests that comprehensive planning, which often includes an investment policy statement, can help reduce sentiment-driven flights to safety by individual investors. Shapira and Venezia (2001) also reported that professional managers were less susceptible to behavioral biases, such as the disposition effect, and that individuals can reduce losses from behavioral investment mistakes by delegating some decision-making to professional advisers.

Table 11.2 shows results from multivariate analyses in order to estimate the independent impact of using a financial planner on household financial outcomes. The nationally representative data include nearly 5,000 households between the age of 42 and 49 with balance sheet information measured in 2007. We examined net worth, wealth held in sheltered retirement accounts, ownership of an Individual Retirement Account (IRA), and whether the respondent had calculated the amount of money needed to save for retirement. These are related to demographic and socioeconomic controls¹ as well as an indicator of whether the respondent consulted a financial planner in preparing for retirement.

The evidence shows that consulting a financial planner is positively related to net worth and retirement wealth even when controlling for income, education, and cognitive ability. Those who have consulted a financial planner were five times more likely to have calculated their retirement needs. Although it is possible that financial planners are more attracted to households that have accumulated greater assets, the strong impact of the financial planner variable on sheltered retirement saving and ownership of an IRA suggests that the use of planners may be responsible for the positive financial outcomes. As noted by James (2011), the financial planning process often involves encouraging clients to engage in intertemporal decisions that they would otherwise avoid. In other words, the financial planning process can force households to acknowledge tradeoffs between present consumption and future goals, and the use of a planner appears to help clients select investment vehicles (such as tax-sheltered accounts) that are best suited to meet these goals.

Incentives and investment advice

Mutual funds with lower expense ratios consistently underperform mutual funds with higher expenses, since there is little evidence that fund managers are generally able to achieve returns exceeding index benchmarks (Fama and French, 2010). Despite this inverse relation between fund fees

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TABLE 11.2 Financial planner regressions

Household characteristics	Net worth ^a	Retirement wealth ^b	Own IRA ^c	Calculated retirement needs ^d
Financial planner	0.449***	1.190***	2.133***	6.038***
Log(Income)	1.591***	1.803***	1.430***	1.458***
Log(Net worth)	–	–	1.184***	1.023*
<i>Education (reference < high school)</i>				
High school	0.109	0.920***	2.703*	1.117
Some college	0.008	1.036***	2.689*	1.139
College	–0.089	1.386***	2.979**	1.235
Graduate school	–0.242	1.531***	3.266**	1.221
Male	0.025	–0.557***	0.811**	1.04
Married	0.314**	0.585***	0.895	0.770**
Children	–0.039	0.177	1.005	0.935
IQ	0.014***	0.047***	1.028***	1.010***
<i>Age (reference 43–44) (years)</i>				
45–46	–0.006	0.0900	0.996	1.088
47–48	–0.064	–0.006	1.019	1.214*
49–51	–0.062	0.145	1.230*	1.201*
Own home	3.222***	1.539***	1.387**	1.376***
Own business	0.298	–0.277	1.602***	1.123
Inheritance	0.435***	0.146	1.388***	0.995
Divorced	–0.052	–0.580***	0.832	0.837
Working spouse	–0.028	0.849***	0.83	0.875
<i>Region (reference South)</i>				
North	–0.089	0.643***	1.356***	0.893
Northeast	0.085	0.605***	1.420***	0.808***
West	0.199	–0.122	1.213*	1.081
Sample size (<i>N</i>)	4,987	4,987	4,962	4,970
Adj. <i>R</i> ²	0.4354	0.3396	0.3002	0.2575

^a This regression models the predictors of log household net worth.

^b This regression models the predictors of assets held in all tax-sheltered retirement accounts.

^c This regression models the predictors of holding any money in an IRA, Keogh, variable annuity, or other tax-advantaged account.

^d This regression models the predictors of having calculated retirement income needs in retirement.

Note: ***, **, and * indicates significance at the 0.01, 0.05, and 0.10 levels, respectively.

Source: National Longitudinal Survey of Youth (NLSY79) 2008 data.

and performance, only 14.5 percent of equity mutual fund assets were invested in lower-fee index funds in 2010 (ICI, 2011). One explanation for this pattern is that higher-fee funds provide compensation for both fund management and investment advice. Investors seeking advising services buy a product that combines advice with mutual funds, providing the adviser with indirect compensation for the added-value portfolio

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recommendations. In a competitive market, variation in fund fees may reflect the value of add-on advising services (Coates and Hubbard, 2007).

Another explanation for the persistence of high fund fees may be that the market for mutual funds is segmented by consumer sophistication, where higher-fee funds may cater to less-sophisticated investors through financial adviser intermediaries, and lower-fee funds cater to more sophisticated investors through a direct-sales channel. Del Guercio et al. (2010) report that mutual fund families tend to focus on catering either to direct channel investors who are more sensitive to performance, or to broker channel investors who value brokerage in-kind services above fund performance. For example, direct channel mutual funds devote more resources to hiring better quality fund managers to attract assets from investors who primarily search for investment returns. The difference in investor clientele may explain why Bergstresser et al. (2009) find that mutual funds recommended by brokers tend to underperform on a risk-adjusted basis. Those authors conclude that such underperformance provides evidence that professional financial advisers do not add value in terms of investment selection. Nevertheless, professionals may still be providing value through services incidental to the recommendation of mutual funds.

According to the Investment Company Institute (ICI, 2007), the primary reason households seek financial advice through brokers who sell mutual fund investments is to draw from their expertise in asset allocation and investment options. Most financial advisers, whether they provide advising through a broker-dealer, an insurance company, bank, or other financial institution, obtain compensation through product commissions or a combination of commissions and fees (Turner and Muir, 2013). Commissions are often subtracted from the value of the financial product immediately after purchase, resulting in an immediate negative return on the value of the investment. For example, a household investing \$20,000 in Class A mutual fund shares with a 5 percent front-end load pays \$1,000 in commissions, leaving a balance of \$19,000. Since no-load substitutes are readily available, this short-term loss in wealth must be compensated by a long-run gain in household satisfaction from the use of an adviser. Financial advisers who are compensated through commissions often justify the commissions as payment for the value of their advising services. Nevertheless, such advice must be incidental to the sale of the financial product to their customers according to the Securities Exchange Act.

An important attribute of mutual fund adviser compensation is that it often goes unrecognized by fund investors. The most opaque form of compensation is not front-end loads, but recurring 12b-1 fees that provide a trail of compensation to the broker paid for by the investor and disclosed only as part of the total fund expense ratio in the fund prospectus. This form of compensation accounts for the popularity of fund shares classes

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(Class C) which involve adviser compensation that is more difficult to assess than the decrease in net asset value when an investor buys front-end load (Class A) shares. Such fees were originally framed as marketing and distribution expenses when they were authorized by the Securities and Exchange Commission (SEC) in 1980, but they have been transformed over time into a broader form of compensation. Evidence of the importance of shrouded mutual fund fees comes from industry resistance to the SEC's proposal to improve fee salience (ICI, 2010). Gabaix and Laibson (2006) present a model where product attributes are shrouded in order to segment the market between naïve consumers, who are unable to detect differences in the shrouded attribute, and sophisticated consumers who are aware of the attribute. Fees that are automatically deducted are attractive to sellers because they often go unrecognized by consumers (are less salient), reducing consumer sensitivity to pricing (Finkelstein, 2009). In one interesting case, a regulatory change in India briefly allowed closed-end funds formed within a twenty-two-month period to shroud expenses by amortizing their cost over time in a manner similar to 12b-1 fees. Anagol and Kim (2012) find that forty-five closed-end funds were initiated during this brief period, compared to just two closed-end funds in the previous sixty-six months and none after the period ended. These funds captured half a billion dollars in excess fees during this brief period, presumably because the shrouded fees made the funds appear more attractive to unsophisticated investors.

Compensation and agency costs

Agency costs occur in any transaction where a principal hires an agent to act on its behalf. Although advice relationships may not involve the actual delegation of decision-making to the agent, the agent's superior information creates an opportunity to provide advice leading to decisions that can favor the advisor's interests over the client's. Financial advice resembles a credence good because it is often impossible for the consumer to judge the quality of the recommendation, for example investment in a mutual fund, even after purchase. To do so would require the human capital needed to assess relative fund performance—a skill that most consumers lack (Beshears et al., 2011). When an advisor receives greater compensation from recommending an underperforming fund, he may do so to the extent that his recommendation is not constrained by regulation or by the possibility of losing future business.

An omniscient and selfless advisor would provide a set of recommendations that maximize the client's expected welfare. Yet, it is neither practical nor economically efficient to expect that a financial adviser will always act

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entirely in the interest of the client. Jensen and Meckling (1976) identify the means through which principals can seek to minimize the costs of delegating advice. First, people can monitor advisers by periodically assessing the quality of their advice. Yet, most consumers lack the financial knowledge to monitor effectively so the monitoring may be most efficiently delegated to an impartial expert acting on behalf of investors (e.g., through the SEC or the Financial Industry Regulatory Authority (FINRA)). Second, advisers can restrict their own capacity to make self-serving recommendations through bonding. For instance, advisers who obtain the Certified Financial Planner professional designation must maintain a fiduciary duty toward their clients. By obtaining a designation that voluntarily restricts the adviser's ability to extract rents from a client, an agent provides a signal of reduced agency costs in order to increase demand for his services. Third, the principal and agent can create a contract to align the interests of the client with the adviser. The most common contracts in the financial advice industry are product commissions, fees levied as a percentage of assets under management, a combination of commissions and asset fees, and a fee-for-service model where advisers are compensated for creating a plan or by the hour. The most common forms of compensation for broker-dealers are commissions or a combination of commission and fees, and assets under management fees dominate other forms of compensation among investment advisers (Dean and Finke, 2011).

The regulation of investment advisers as fiduciaries provides a bonding mechanism enforced by a government entity that can efficiently monitor excessive rent-seeking behavior. FINRA regulates advisers based on a standard of suitability. Suitability provides constraints on adviser behaviors that are much more explicit than the fiduciary bonding mechanism provided through regulation by the SEC. However, advisers who are constrained by rules have an incentive to maximize rent-seeking behavior within the boundaries of those rules to the extent that doing so is in the best interest of the agent.

As previously mentioned, many consumers have little understanding of how much they pay for financial advice or the potential conflicts of interest related to adviser compensation (Hung et al., 2008). Commission compensation is generally opaque since many investors are unaware of how much they pay for investment loads, and disclosure does not appear to alleviate this confusion (Beshears et al., 2011). In a market where price is less visible, advisers have an incentive to maximize commission compensation constrained by suitability requirements and the risk of losing future revenues from the client through excess rent extraction. As an example, commissions for mutual funds often decrease on a sliding scale of breakpoints, where larger amounts invested result in a lower commission applied to all

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invested funds. An adviser hoping to maximize commissions could allocate an investor's wealth across funds within a family in order to maximize commissions, a possibility that motivated the SEC to create a task force to eliminate the practice (NASD, 2003).

The financial advice profession often does not meet the same standards of other professions due to the co-mingling of advice with product, which creates potential conflicts of interest (Frankel, 2010). Of course, agency costs will always exist in any market where a consumer must delegate decision-making control to an expert; many financial advisers are not held to a legal standard that requires them to make recommendations that are in the best interest of the client, unlike most advice professionals. Many of these advisers, who need only recommend products that are potentially suitable to the household, use professional titles (financial consultant, financial planner) that are similar or identical to the titles used by advisers who are regulated as fiduciaries. Most who use an adviser, even the more educated and wealthy, are not able to differentiate between the two (Hung and Yoong, 2013).

Commission compensation incentivizes an adviser to sell financial products but does not provide incentives to invest passively. In fact, Mullainathan et al. (2012) report that financial advisers often encourage clients to engage in return-chasing behavior, possibly to increase the frequency of trades in a manner that takes advantage of (rather than discourages) the behavioral instinct to focus too much on investments with high recent returns. These high sentiment investments are then likely to underperform subsequently (Frazzini and Lamont, 2006). Indeed, Bullard et al. (2008) find that investors who bought mutual funds through a broker channel underperformed no-load investors by 150 basis points, primarily because of poor investment timing. Anagol et al. (2012) also found that commission advisers did not de-bias behavioral clients when it was not in their best interest to do so.

A market with naïve consumers and shrouded pricing creates an opportunity for commission advisers to recommend products that maximize commissions at the expense of consumer welfare. For instance, in India, Anagol et al. (2012) found that insurance agents routinely recommended inferior products to less knowledgeable customers, while simultaneously recommending more suitable products to more sophisticated customers. When given a choice between recommending more competitive products that required price disclosure, and more expensive products that did not, insurance agents recommended the latter. This tendency to recommend inferior products with opaque pricing may be even more acute in a competitive marketplace if consumers are unable to detect the cost of the commission product. Agents who recommend lower-cost, lower-commission products will ultimately be forced out of business by agents recommending less

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suitable, higher-commission products who are able to use the excess revenues to increase marketing expenses, rent better placed office suites, and hire more talented employees.

Among those who charge fees for financial planning services, 97 percent base their fee amount on assets under management (Hung et al., 2008), a practice that may lead advisers who charge fees to prefer higher-wealth clients. Dean and Finke (2011) explore SEC compensation disclosures among the 7,043 registered investment advisers in the United States and found that those who charged commission compensation were more likely to cater to lower net worth clients and were more likely to provide financial planning services.

Fees may also reduce the focus on short-term advising services by creating an incentive to establish a long-run advising relationship. For example, Finke et al. (2009) found that households that used financial planners (who are often investment advisors compensated primarily by asset fees) were far more likely to have adequate life insurance coverage than households who obtain financial advice from brokers. If brokers were primarily concerned with receiving compensation from the initial sale of investment products, they have little incentive to provide more comprehensive financial advising services. However, fee compensation is not free of potential agency costs (Robinson, 2007). Advisers are not able to receive compensation from non-investible assets, so they may be more likely to recommend the liquidation of assets such as investment real estate or business equity. They may also be less likely to recommend annuitization since this would reduce the amount of invested assets. Fee compensation may also create a disincentive to reduce debt in an investor's portfolio since this would require a reduction in assets. There also appears to be surprisingly little price competition among investment advisors (Hung et al., 2008). This may be because asset-based fees are analogous to income taxes, which are less salient to taxpayers, while fixed and hourly fees more closely resemble property taxes, which taxpayers seem to care much more about because the amount paid is more readily apparent (Cabral and Hoxby, 2011).

Potential regulatory alternatives

One way of reducing increased agency costs that arise from commission compensation might be to eliminate commissions and apply a uniform fiduciary standard among financial advisers. To this end, the UK Financial Services Authority (FSA) has proposed eliminating commission compensation on retail investment products in 2013 (FSA, 2011). The FSA has argued that commissions can produce incentives to withhold information or take advantage of the information imbalance to sell products with a low

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likelihood of being declared unsuitable by regulators. Australia's Future of Financial Advice Committee has also recommended eliminating commissions and applying a fiduciary standard of care to investment advisers. Finke and Langdon (2012) explore differences in US state common law standards for broker-dealers to compare non-fiduciary to strict fiduciary states. They find no evidence that stricter fiduciary standards reduce the number of registered representatives within these states, or negatively impact representatives' ability to recommend commission products or provide services to lower-wealth clients. A universal fiduciary standard could reduce incentives to recommend suitable products that are nonetheless inferior to other available products. It could also reduce consumer confusion about the unequal application of fiduciary standards between brokers and investment advisers.

Surveys in the United States and in Australia suggest that most respondents would prefer commissions over fees when paying for financial products, and that the amount they would be willing to pay for financial plans is generally much lower than the amount advisers commonly receive (e.g., Australian School of Business, 2010; Ody, 2011). This is consistent with evidence that mutual fund investors appear to reward funds with more opaque expenses, despite strong evidence that opacity is negatively related to performance (Edelin et al., 2012). Disclosure increases competitiveness and efficiency, but less sophisticated consumers gravitate toward products with opaque pricing. This demand for inferior products with shrouded prices may be caused by an underestimation of the actual cost in the absence of full information. In a model of naïve and sophisticated financial consumers with hidden sales incentives, Inderst and Ottaviani (2011) find that naïve households will likely be exploited while sophisticated investors may benefit from broker incentives that increase efficiency in response to market pressures (much like dealer kickbacks on slow-selling cars allow dealers to negotiate lower prices). There is little evidence, however, of many sophisticated consumers who are able to perceive advice conflicts of interest (Hung et al., 2008).

Of course, it is also possible that fewer average investors would be served by advisers if they were unwilling to pay market prices for expert financial advice. Preference for commission compensation may persist if consumers assume that the prices they pay for advice are much below the full price. This leads to the counterintuitive conclusion that many households would be unwilling to pay for advice if they knew the cost might actually benefit from shrouded pricing.

In addition to differences in compensation and regulation among financial advisers, there may be important differences in financial planning knowledge that bias estimates of the value added from financial advice. Education ranges from a university degree in financial planning that

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includes specific instruction in investments, tax, retirement, estate, and insurance topic areas, to a brief proprietary training session focused on product characteristics and suitability requirements. Registered representatives of broker-dealers must pass a 7-hour Series 7 examination through FINRA that primarily tests product knowledge and regulation. Registered investment advisers generally must pass a 3-hour Investment Adviser Competency Exam that also emphasizes knowledge of securities and regulation. The Certified Financial Planner examination is a two-day examination that includes topic areas focused on knowledge specifically related to providing comprehensive financial advice. Certifications can provide a quality signal, but only if unqualified advisers are unable to obtain the certification. A proliferation of certifications within the financial advice industry means that consumers are often unable to determine which are credible quality signals. To some degree, household financial advice suffers from inconsistency because it has not developed as a science-based profession with uniform best practices and quality standards.

Age and financial advice

The most frequent reason given for not seeking professional advice among respondents aged 60 or over is an unwillingness to hand over control of investment decisions (ICI, 2007). The percentage of households under age 45 unwilling to delegate control over investments (57 percent) was much lower than households aged 60 or older (82 percent). The second most frequent reason driving the decision to avoid professional advice among respondents in the oldest age group is the belief that they have all the knowledge they need to invest on their own (ICI, 2007). The percentage was again higher than among younger age groups.

This pattern is confounded by the fact that efficient processing of mental stimuli and the ability to place it into context, or fluid intelligence, peaks in young adulthood. Problem solving involving a combination of knowledge and experience (crystallized intelligence) peaks around age 60 (McArdle et al., 2002). Financial decisions require some mathematical skill, but they primarily involve the ability to process complex information and place it into context in a manner consistent with other decision-making domains that require crystallized intelligence. For example, taking a sheltered investment portfolio and turning wealth into an income stream during retirement require knowledge of available financial instruments including annuities and traditional investment products, an understanding of complex and constantly changing tax laws, and knowledge of investment and economic theory. A study of credit decisions found that credit making decision quality peaked in the mid-50s and declined in a manner

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similar to the observed decline in crystallized intelligence (Agarwal et al., 2009).

The Baby Boom cohort is the first having to deal with turning 401(k) and IRA assets into consumption during retirement, and its ability to make welfare-maximizing choices is likely to decline as the group ages. Finke et al. (2011) show that basic financial literacy skills decline by about 2 percent each year after age 60. The decline is consistent among all decision-making domains, including insurance, investments, credit, and basic literacy, and the decline occurs even among the most educated and financially sophisticated respondents. Somewhat ironically, although financial decision-making abilities decline throughout old age, confidence in financial decisions does not. Finke et al. (2011) find that confidence increases significantly in old age, though more educated respondents are less (over)confident in their financial decision-making abilities. Overconfidence in financial abilities may explain why fewer respondents aged 60 and older believe they would benefit from expert financial advice (ICI, 2007).

This decline in competency with tasks requiring fluid intelligence suggests that older households are able to modify behavior to avoid mistakes. Thus, aging erodes our ability to process and react to visual stimuli while driving, though the decline is so slight that many older drivers do not perceive it. The good news is that, when confronted with objective evidence of diminished driving skills, subjects subsequently changed their driving patterns by driving during low-traffic times and avoiding complex intersections (Holland and Rabbitt, 1992). By acknowledging an inevitable decline in financial decision-making ability, older households may be more willing to delegate financial decisions to an expert or to choose investments that are easier to manage such as annuities or automatically rebalancing mutual funds.

Conclusion

There is ample evidence that households who lack the financial knowledge needed to make efficient choices in an increasingly complex financial marketplace. Financial advice professionals can substitute for costly and inefficient investment in finance-related human capital by households, if the expected benefits from better decisions exceed the costs of advice. Yet financial advisers are often compensated through opaque commissions and non-salient fees. Accordingly, the benefits from advice are fraught with potential conflicts of interest.

For these reasons, a financial advice market that functions well is needed to arm a new generation of consumers tasked with increased responsibility for funding retirement with the information needed to make efficient

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choices. Ensuring that consumers have access to well-educated financial advisers whose job is to make recommendations in the best interest of the consumers seems a logical solution to this consumer information problem. There is evidence that consumers who seek advice from fiduciary planners who provide comprehensive advising services are much better off than those who do not receive advice. Yet even the most sophisticated consumers are sometimes unable to identify which advisers are most likely to provide good advice, due to a patchwork of adviser regulations and the customer's inability to recognize genuine quality signals.

Equity markets in countries with greater investor protections are healthier because stock owners have reason to believe that managers will look out for their interests despite significant information asymmetries (La Porta et al., 1998). It is likely that the health of the financial advice market in the future will depend on whether consumers are confident that the advice professionals they hire are people whose recommendations they can trust. Other countries are closer to the adoption of consumer protections on advice compensation and fiduciary regulation. In the United States, an early version of the 2010 Dodd-Frank Act would have applied fiduciary standards to all financial advice professionals. Some who benefit from non-fiduciary regulatory standards would oppose this legislation, but like equity and insurance markets characterized by information asymmetry, increased consumer protections can engender trust and increase demand for a much-needed service.

Endnote

1. Net worth and income are log transformed and negative values are set equal to one prior to transformation.

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