Middle Class Economics Forum
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I became interested in studying the market for financial advice because the incentives of advisors might affect the quality of advice that they give their clients. In particular, the fact that many of them are paid via the fee income that they generate from their customers, can lead to serious conflicts of interest. These problems can even be aggravated if a large fraction of consumers are poorly informed about finance: it might make it difficult for upstanding financial advisors to compete effectively, since the less sanguine advisors might lure consumers with exaggerated claims about their products.

With my coauthors Sendhil Mullainathan at Harvard University and Markus Noeth at the University of Hamburg we set out to test the quality of the advice that is commonly given to clients: We sent "mystery shoppers" to make more than 250 financial advisor visits in the greater Boston and Cambridge area. They impersonated regular customers who are seeking advice on how to invest their retirement savings outside of their 401K plans. These were professional mystery shoppers, half of them in their 30s and half in their early 50s. We also varied the levels of bias or misinformation about the financial markets that the clients represent to see whether advisors correct the mistaken believes of consumers. For example, in half of the visits mystery shoppers presented mistaken believes about financial markets, such as wanting to chase past returns or holding their savings in the stock of the company they work for (these are well documented biases that have been shown to create poor returns). Other mystery shoppers went into the advice situation with what you might call a "text book" portfolio: well diversified, low cost index funds.

The results we found were quite troubling: On average the advice our shoppers received failed to correct their biases. Even more troubling, the advisors seemed to exaggerate the existing misconceptions of clients if it made it easier to sell more expensive and higher fee products to them. In addition, advisers strongly favored actively managed funds over index funds. In only 7.5% of sessions did advisors encourage investing in index funds. While in 50% of the sessions they strongly pushed clients to move their savings into actively managed funds. But this is exactly counter to the insights from finance research, which suggests that the average investor should choose low-cost index funds. If advisers mentioned fees, they usually downplayed their importance.

Finally, we found that advisors who have fiduciary responsibility towards their clients provided better and less biased advice than those who are merely registered as brokers. The former were less likely to move people away from index funds and to reinforce erroneous believes about the market.

So what can be done to reduce these problems? Reducing the conflict of interest between advisors and clients is a first order concern. This is not only good consumer financial protection but also good for harnessing market competition in the interest of consumers rather than against them. It should encourage financial advisory firms to compete on dimensions that are in the benefit of clients and not on how to mislead them about returns and product pricing.

We can also learn from some of the attempts in other countries: For example Germany introduced a rule that financial advisors have to explain to their customers in detail how they are paid at the beginning of an advice session. But this intervention did not have a noticeable impact. It is just too easy to inundate a consumer with so much information that they do not understand what the actual fee structure is. In comparison, the UK has taken a more drastic approach: It banned any performance payments from mutual fund companies to advisory firms. My concern is that these, very micro-managing interventions, can have unintended consequences. For example they might benefit those advisors who are fully integrated with one mutual fund family, but drive out advisory firms that are independent. Or it might just lead to a proliferation of other forms of side payments.

Therefore, improving the fiduciary standards for financial advisors in my opinion is a good middle path. It preserves the flexibility of the industry to decide how to organize the provision of advice, but still ensures that they are acting in the interest of their clients. One important caveat is to understand that investing in financial markets is always risky. So fiduciary standards should be imposed on the soundness of the advice going in. But advisors should not be opened up to frivolous lawsuits just because the market went down and a client experienced any losses.