The Way Forward: Independent Advice and Trust

Given what has recently occurred throughout our financial system and economy, there will undoubtedly be significant changes to many aspects of the financial services industry, including regulation, compensation, disclosure and risk assessment. What won't change is human nature. This wasn't the first "bursting of a bubble" and it certainly won't be the last. Nonetheless, it is my opinion that the most recent financial turmoil will accelerate a trend toward a more skeptical and more educated investing public. Given the growth of the independent advisory industry over the past 20 years, coupled with an explosion of lower-cost and more tax-efficient investment vehicles, there is now an established alternative for those investors who no longer believe that a product-focused, commission-based firm will place their clients' best interests ahead of their own. Without the trust of their clients, Wall Street will have nobody to service; this will ultimately force the industry to change. Additionally, the competence of many investment professionals has been questioned. After all, *if some major financial institutions need government assistance to survive and they can't properly manage their internal portfolios, is it reasonable to assume that these firms can properly manage a client's portfolio?*

Trust

A recent study by Forrester Research (*Source: Forrester Research Customer Advocacy Rankings*), summarized by Suzanne Duncan of the IBM Institute for Business Value, a business services consulting division of IBM and Jane Kim of The Wall Street Journal, shined a bright light on perhaps the most pressing issue faced by major financial institutions: trust, or lack thereof. According to the study, approximately *70% of the clients of financial institutions hold the belief that financial institutions act in their own best interests, not in the best interests of their clients*. Perhaps more surprisingly, *approximately 60% of financial institutions agree that they are acting in their own best interests!* While every category of financial service companies has room for improvement, independent investment advisors, credit unions and property & casualty insurers scored the highest while full-service brokers scored the worst.

An integral aspect of developing a mutually-beneficial relationship based upon trust and integrity is making sure that the interests of all parties are aligned. I believe this is best accomplished through an advisory fee-based compensation structure as opposed to a product-driven, commission-based compensation structure. As explained in Charles Schwab's *The Right Investment Advisor Does What's Right For You*: "Independent advisors typically charge a fee based on a percentage of total assets managed. This has two advantages. One: The fee structure is simple and easy to understand, helping to avoid surprises. Two: Since this fee structure does not give your advisor an incentive to recommend one product over another, you can feel confident that your advisor is making recommendations based on what's best for your situation and your portfolio." Human nature is human nature and people respond to incentives, including financial incentives. Commission-based professionals should certainly not be viewed with contempt, but an informed consumer of financial services should at least understand how the person sitting across from them is compensated. *Most people know exactly what they paid for a car or a television or a gallon of gas but very few know what they are paying for financial services. If you don't know what you're paying for something then there is a good chance that you're paying too much.*

Competence

With any luck, enhanced disclosure requirements will be included in any regulatory reform of the investment industry. Given the fact that an overwhelming majority of active managers (75% or so depending upon the asset class and time period) continue to underperform their appropriate passive benchmark and that there is no persistence in outperformance (*Source: Standard & Poor's*), it might seem peculiar, or even amazing, that most equity assets are held in relatively expensive actively-managed products. In my opinion, this is a direct result of the compensation structure for most investment professionals and the problem has been perpetuated because of poor disclosure of the facts. Whether it's a commission-based broker or a hedge fund manager, most investment professionals are paid to gather assets for specific investment products; they are not paid to provide objective advice. The result shouldn't be a surprise. What is surprising is that relative performance and fees can be buried deep within a 70 page prospectus. According to Suzanne Duncan of IBM, approximately 70% of assets are currently invested in traditional actively-managed products and it is her opinion that a majority of this money will shift to passive investment products over the next twenty years. The traditional full-service brokerage firms, mutual fund companies and hedge funds have a lot to lose if Suzanne Duncan is correct so I would expect the entrenched industry players to continue their substantial marketing and lobbying efforts (their two core competencies). Ultimately, *I believe this shift away from traditional brokerage firms and active management is inevitable because facts are stubborn things.*

An Alternative Solution

Fortunately, there are thousands and thousands of independent investment advisory firms all across the country that are in a great position to provide an alternative investment experience to those investors who no longer have confidence in the entrenched legacy firms and managers. The investment advisor representatives at Passive Capital Management, LLC are proud to be members of this independent group and we believe that we are uniquely qualified to provide independent advice and put clients' best interests at the forefront. For example: Registered Investment Advisors, such as Passive Capital Management, have *fiduciary (legal) responsibility for managing someone else's money*. This means we have been placed in a position of trust and that we must manage accounts according to a prudent investment philosophy and manage the assets for the benefit of the client rather than for our own best interest. Most brokers are not fiduciaries.

Clients' assets are held by an institutional custodian. Our *clients' assets are held and protected by Charles Schwab & Company*, who has serviced independent advisors and their clients for over 20 years. They are the leader in the industry. At no time does Passive Capital Management take possession of clients' assets; we simply manage portfolios on behalf of our clients. This relationship with Charles Schwab acts as a system of checks and balances, providing clients with *complete transparency* and confidence.

We *do not get paid commissions for selling specific investment products*. As a result, we are free to choose the best products to most effectively help our clients accomplish their goals – "best" generally means the most diversified, most tax efficient and least expensive. We have a simple fee structure and we provide quarterly invoices so clients know exactly what they are paying.

We don't pretend to be a non-profit organization but we do align our interests with those of our clients and we do provide complete transparency into everything we do so that prospects and clients can make an informed decision regarding their investment options. We can't control what the markets will do but we will continue to control all of the other variables that affect portfolios, such as asset allocation, diversification, tax efficiency, costs and rebalancing. We hope all of these things will enable us to enjoy mutually-beneficial, long-term relationships with all of our clients.

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