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## The Study of the Decade

Donald Moine | 06-22-06

Over the next few years, you will be hearing a great deal about a ground-breaking new study that is just now starting to receive nationwide attention.

The only notice of it that I have seen in the public media just appeared in a popular money magazine: "A new study compares the cost and performance of more than 4,000 mutual funds--some sold by brokers, some selected by people on their own--from 1996 to 2002. The people won." In other words, do-it-yourselfers outperform financial advisors.

Was the difference trivial? In another section, the article stated, "Estimated annual amount by which funds that people bought on their own outperformed broker-sold funds: \$8.8 billion." The number \$8.8 billion was in very large type.

Those are fighting words. But more and worse is to come from the popular media. This monumental study will surely be misinterpreted by some in the media. Clients could be outraged. A few may vote with their feet.

The questions we must ponder is, "*How do we defend ourselves? How do we establish our economic value?*" The vast majority of all financial advisors have long assumed they helped their clients achieve financial goals. At least when it comes to mutual fund investing (the most common service financial advisors offer), this study implies that financial advisors add no value.

Within weeks, the popular media will be writing articles stating that financial advisors harm clients. Jonathan Clements, one of the most popular columnists in *The Wall Street Journal*, has long contended that most people would be better off by avoiding financial advisors and just putting their money in the bank. He may now have rigorous scientific proof to back up his arguments--and many other journalists and thought-shapers are sure to join the chorus.

### The Study

"Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry" is written by Daniel Bergstresser of Harvard Business School, John Chalmers of the University of Oregon, and Peter Tufano of Harvard Business School. While I earned my Ph.D. at the University of Oregon, I have no connection with Chalmers or the other authors.

It is likely that this landmark work will soon become known as the "BCT Study" just as we all refer to the seminal work on asset allocation as the BHB study after the initials of its authors.

The BCT study is an exhaustive analysis of the cost and performance of more than 4,000 mutual funds sold by financial advisors and selected by investors on their own over the years 1996 to 2002. The amount of data analyzed is staggering. The study has been going on for years and various working drafts of the research findings are available on the Internet. The latest is dated Jan. 16, 2006.

The findings of the BCT study will create a firestorm of controversy. Let's prepare

ourselves now.

## The Findings

First of all, I must explain the usage of the word "broker" in the title of this study. It does not just apply to Series 7 licensed reps who work on commissions and loads. It truly applies to almost all financial advisors who sell mutual funds.

The authors use the term "direct channel" to refer to what we might call "the public" or "do-it-yourselfers." This includes investors who buy mutual funds directly, on their own, or through no-load fund supermarkets.

All other mutual funds that are sold through banks, advice givers, RIAs, IARs, broker-dealers, mutual fund wrap accounts, wire houses and captive agents are included in the author's "broker channel." Unless you work for a fund supermarket on a salary, you are referred to as a "broker" in this study.

In short, the authors' findings probably apply to the vast majority of all financial advisors, whether they are RIAs, IARs or registered representatives.

This is the first study ever to scientifically quantify the benefits that investors may enjoy if they work with financial advisors. The authors asked these essential questions:

1. Do advisors give clients access to funds that are harder to find and evaluate? The answer is yes, but as you will see, as a whole, *advisor-selected funds underperform funds that investors select on their own.*
2. Do advisors help clients find funds that are lower cost (excluding distribution costs)? After analyzing several trillion dollars worth of transactions, the answer is no.
3. Do advisors give clients access to funds with better performance? The answer is a resounding no. I know this is shocking--and it may not apply to you. But the scientific evidence shows that many of the other advisors in America not only underperform indexes--they underperform what most people do on their own if they don't have an advisor.
4. Do advisors provide superior asset allocation? After years of research covering trillions of dollars of asset allocations, the finding is that advisors do not provide superior asset allocation. Even without this study, one only had to look at how advisors overemphasized technology funds in the late 1990s and how many advisors are overemphasizing energy, gold, and foreign funds today.
5. Do advisors help correct bad investor behavior such as chasing fads and chasing performance? The sobering answer is no. In fact, the evidence shows that advisors even contribute to such behavior. Again, look at all the money advisors are pouring into energy, gold, and foreign funds.

It is important to note that the authors are not anti-advisor. Remarkably, they had the cooperation and support of some of the largest and most respected industry groups and research organizations in America in working on this study. Further, the authors go out of their way to point out that financial advisors may offer significant "intangible benefits."

Unfortunately, these researchers found that the clients of advisors buy funds that have substantially higher fees and lower risk-adjusted returns than funds that investors buy on their own. The implications of these findings are staggering. The BCT study may even affect public policy toward advisors in the future.

## What Will Compliance Departments Do?

None of us is perfect. So advisors underperform what investors can do on their own--so what? Underperformance is bad enough, but the BCT study finds that investors pay billions of dollars a year for this underperformance.

Reading this study, one wonders how compliance departments will react. The methodology of the study is rigorous and sound. The massive amounts of data involved have been analyzed for years from many different angles. Researchers from major universities around the country have contributed guidance and expertise to the authors. Morningstar and Financial Research Corporation contributed data (although the findings of the study and the conclusions drawn can only be attributed to the authors.) In addition, staff members of the Investment Company Institute and representatives of various mutual fund companies assisted the authors. This is not a biased study.

There are no studies of which I am aware that can contradict the findings of the BCT study. An implication of these findings is that investors suffer a loss of billions of dollars a year in lower performance and in fees if they hire financial advisors to select mutual funds.

A few advisors who have read the BCT study have asked, "Will compliance departments require advisors to disclose that that advisor-provided advice may hurt them?"

That is very unlikely. You don't have to worry about compliance departments raising their standards because of the BCT study.

It is a virtual certainty that financial advisors all over the country, even those who have only been in the business for a week, will still be able to tell prospects, "I can pick the best mutual funds in America for you." Even advisors who have lost their clients millions or tens of dollars will still be able to make this claim because no compliance department forbids or even regulates this statement.

This does not mean, however, that the BCT study will not have a huge impact on practice building. You had best be prepared for clients asking you questions about this study.

Many prospects will probably almost always believe advisors who say they can pick the hottest mutual funds. However, a few years after prospects become clients, questions arise. "Why am I not making very much money?" "Why am I losing money?"

In the past, pat answers worked: "We're in for the long term." "It's not timing the market, it is time in the market." "Be patient. We'll make money over the next five or 10 years."

However, there is a good chance that these well-worn answers will no longer suffice once the findings of the BCT study become known. I've shared this study with a few million-dollar producers and they are already preparing their responses.

I am myself preparing speeches to help advisors deal with the BCT study, and I'm working with advisors around the country on their responses. However, in addition to knowing what to say, *advisors must also change their behavior.*

It is the unprepared advisors who will be caught flat-footed and who will suffer the greatest loss of clients as the BCT study hits the nightly news. Unfortunately, the clients you are most likely to lose are your better-educated and highest-net-worth clients.

The BCT study also found that the clients of advisors are less educated and have lower net worth than do-it-yourselfers. The findings of the BCT study are likely to increase the exodus of bright high-income clients who may decide it is better to simply buy low-cost index funds on their own. Let's work together to stem that tide.

## The Good News

I am a perpetual optimist. In my speeches and in my work with top advisors, I always like to stimulate deeper thinking, provide solutions, and to leave advisors feeling good about the future.

Don't be depressed about the BCT study. Ultimately, it will strengthen our profession and improve the results we deliver to clients. For much too long, some advisors have been engaging in investment practices that provide minimal or non-existent benefit to clients. For example, **the BCT study found that the raw returns of equally weighted mutual funds (net of all expenses) for 1996 to 2002 were 6.626% for the investors working on their own and were 2.924% for funds provided by advisors.**

In other words, *the public working on its own did more than 100% better than financial advisors when it came to selecting equity mutual funds.* After factoring in inflation and taxes, clients of financial advisors lost money and lost purchasing power. This must change.

You don't have to lose clients because of the BCT study. Many of the income planners I am coaching have done very well for themselves and their clients by offering combinations of tax-free bond funds, covered call stock funds and other investments. For example, MuniHoldings CA Insured MUC, a closed-end bond fund that has historically produced about 6% per year tax-free over long periods of time, outperforms the vast majority of all mutual funds on an after-tax basis--yet very few advisors know about it.

Another investment class that is relatively unknown to most advisors is covered call funds. Funds such as Madison Strategic Sector Premium Fund MSP, pays nearly 10% per year, invests in high-quality stocks, and can make money from call-writing even if the market is flat.

How many advisors make money from equities in a flat market? Very few. However, funds like MUC and MSP help clients prosper even when the stock market is flat or slightly declining. In addition, MSP sells at a discount to net asset value.

MSP and MUC are not perfect--no investment is. Yet when you can earn about 10% per year (taxable) as MSP is doing or 6% per year after-tax as MUC is doing, you do have an advantage over the 2.924% taxable return that so many advisors are delivering.

The implications of the BCT study go far beyond security selection. This paradigm-challenging study points out the need for many advisors to change their behavior. We have long known about the dangers of chasing investment fads, but it turns out that many advisors may be just as guilty as the public.

We must have the courage to occasionally buy companies or sectors when they are out of favor. How many of us have the courage now to buy Intel, the world's largest semi-conductor company, now that it has the lowest price/earnings multiple in its history and is about to release a whole new generation of products? Or Microsoft, which has a similar story?

In future articles, we will take a closer look at the BCT study and how both you and your clients can actually prosper from its startling findings--if you are prepared.

Our world is about to change. Millions of clients and prospects will never see us in the same light again. With the right knowledge, you stand to be a beneficiary rather than a victim of this massive sea change in the perception of financial advisors.

Don't just be a trusted advisor--be a trusted advisor who adds economic value.

*Get practice-building tips and information from our team of experts delivered to your e-mailbox every Thursday. [Sign up for our free Practice Builder e-newsletter.](#)*

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