FINANCIALLY SOUND HOUSEHOLDS USE FINANCIAL PLANNERS, NOT TRANSACTIONAL ADVISERS

SUMMARY OF A PAPER BY DAVID M. BLANCHETT, Ph.D, CFA, CFP

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This blog summarizes the results of one of his papers (Financially Sound Households Use Financial Planners, Not Transactional Advisors) and adds my own commentary.

Blanchett looked at four sources of information that affect household financial decision making:

1. Financial planners;
2. Transactional financial advisors;
3. Friends; and
4. The internet.

By "transactional financial advisors," Blanchett was referring to advisors and sales reps at bank and brokerage firms.

His goal was to determine which sources of information resulted in the best financial outcomes.

Here's a direct quote from his executive summary:

"Households working with a financial planner were found to be making the best overall financial decisions, followed by those using the internet, while those working with a transactional adviser were making the worst financial decisions."

He continues, "households are likely better off working with an advisor that is more comprehensive (e.g., a financial planner) than transactional in nature."

I've written several blogs on this topic before, such as "Transactional vs Advisory Relationship," which explains the difference between a financial planner and a transactional advisor using a car salesperson analogy.

But how about a tax return preparer analogy?

Jack is new in town and is looking for someone to prepare his tax returns. New friends have mentioned two preparers, whom Jack is checking out.

Sally is a CPA who has her own firm. Her clients rely on her to prepare their returns accurately while legally minimizing their tax liabilities in the long term. She takes the fiduciary standard very seriously and makes recommendations for reducing future taxes as well as for improving her clients' long term financial security. But her clients have to actually write a check or hand her a credit card. Ouch!

Joe works for the IRS. He prepares tax returns for free. No need to write a check or hand over a credit card because Joe is compensated by the IRS. The downside? Joe's compensation is based on how much of his customers' wealth he transfers to the IRS when he prepares his customers' tax returns.

I know what you are thinking. Jack would be nuts to choose Joe. And you are right. But Joe is a really good salesperson who convinces his customers that he is on their side. He might even falsely claim to be a fiduciary.

But let's circle back to Blanchett's conclusion that using a transactional advisor results in poor financial outcomes, even worse than relying on the advice of friends and family or the internet.

A true long term comprehensive financial life planner is very much like Sally. She works for the client, looks out for the client's interests, and is compensated by the client accordingly.

A transactional advisor (i.e., a sales rep at a bank or brokerage firm) is very much like Joe. He doesn't work for the client; he works for the bank or brokerage firm. He isn't compensated for enhancing his clients' financial security; he is compensated for transferring as much of his clients' wealth as possible to the bank or brokerage firm.

Here is Blanchett's entire paper, which includes the shortcomings in his study:

https://www.onefpa.org/journal/Pages/APR19-Financially-Sound-Households-Use-Financial-Planners-Not-Transactional-Advisers.aspx

It's a heavy read. So I'll just cite a few more quotes from the paper:

"Households working with a financial planner were found to be making the 'best' financial decisions, in the aggregate as well as in four of the five domains considered, while households working with a transactional adviser were making the 'worst' financial decisions."

"…these findings do at least suggest financial planners are adding the most value among the information sources considered, especially compared to transactional advisers."

"…the majority of research has suggested investors using financial advisors are no better off (or potentially worse off, especially after fees) than those without."

"…it may not actually be in the financial adviser's best interest to help the client make the optimal decision, if that decision does not align with the adviser's method of compensation."

For the purposes of the study, "financial advisers were classified into two types: financial planners and transactional advisers."

(For more on this important distinction, read my blog, "Who is a financial planner?")

"…households working with a transactional adviser were doing the worst in effectively every domain considered. In other words, it's not that households working with a transactional adviser were doing one thing really well and everything else poorly; they were doing everything poorly."

“…households using more comprehensive advisers generated more wealth than those without any help, as well as versus those advisers providing less holistic services.”

For you academics out there:

“For the portfolio risk appropriateness domain logistic regression, only the financial planner coefficient was positive and statistically significant. This suggests the probability of having a portfolio that is even generally consistent with age was higher if the household used a financial planner, but effectively random for the other information sources.”