Transparency - 2011's Buzzword for the Financial Services Industry

The word transparency seemed to almost have been the buzzword in the financial services industry for 2011. Unfortunately, that's about all it was. There was a "call" for more transparency and disclosure for financial advisors; there was recognition of the "need" for transparency, and then, the concept was quickly swept under the rug. Actual transparency with financial advisor / investor relations made very little progress. Why? Well, to understand that, you'll need to understand what's at stake. Whenever there is a lack of transparency (in any industry), there is a reason behind it. In the financial services industry, reasons for the smoke screen can vary, but here are the main motives keeping full transparency at bay.

Transparency Explained

Full transparency, when it comes to investment advice, would include an easy to read and understand document containing all the pertinent facts necessary to make a well informed decision for individuals looking to invest their assets. Sounds simple enough, right? Actually, not only does this request sound simple and reasonable, but it is the only rational way to operate. Investors are dealing with large sums of money. Money they are counting on to provide them with their retirement. You'd think this fact alone would be reason enough for full transparency to be an absolute requirement. Hardly.

Instead, the responsibility for full disclosure rests on the client. It is up to the investor to dig around and try to figure out how their financial advisor is compensated. Even when they do start asking questions, it is often difficult to verify if the advisor is telling the truth. Why the secrecy?

What Are Financial Advisors Trying to Hide Anyway?

Conflicts of interest.

That's the number one reason. Certainly, there are other, often less important reasons, but full disclosure and transparency in the industry would bring the clear conflicts of interest to the surface, which in turn might eventually upset the commission structure of many financial advisors. It's a tangled web, and financial advisors who earn commissions based on the financial products they push to their clients really would rather talk about something other than transparency...probably almost anything else.

In a study published by *The Journal of Legal Studies* (Volume 34) entitled, The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest, Daylian M. Cain, George Loewenstein, and Don A. Moore reported the results of an experiment involving conflicts of interest and how they lead experts to provide biased and corrupt advice. The study further revealed the fact that although disclosure is often proposed as a potential solution to these problems, there is no escape from the perverse effects of conflicts of interest. In fact, the study showed that disclosure can increase the skewed bias in advice, due to the fact that advisors who feel morally licensed mentally justify their information and exaggerate their advice even further. Bottom line? Disclosure and transparency will often make matters even worse. So, if you think that asking your financial advisor about his or her compensation is going to bring integrity to the table, think again. Any financial advisor who sells (or has the option to sell) financial products to earn a commission is going to sway in that direction. It's human nature.

Here are the interesting results of the study:

The Conflict of Interest Study

In this study, volunteers were used to play one of two roles. One group played the advisor while the other group played the estimator. A glass mason jar with exactly $18.16 was set in the middle of the table. The estimator's job was to try to guess the amount of money in the jar. They were rewarded for accuracy.

The advisors were given additional information and their job was to advise or assist the estimator in order to help them estimate the amount in the mason jar more accurately. The advisors were divided into two groups with two different compensation incentives. The first set was rewarded according to how close the estimator came to the correct amount in the jar. The second group of advisors was compensated according to how high the estimator guessed. Accuracy didn't matter with the second group. The higher the estimator guessed, the more the advisor was compensated. Obviously, you can see the correlation here between the test and real life scenarios with financial advisors. One has a clear conflict of interest while the other does not.

The Results

The results of the study were alarmingly true to life. The advisors who were compensated on accuracy alone and assisted their clients in the "estimation" process had an average estimate of $16.48. Remember, the actual amount in the jar was $18.16.

On the other hand, those who were compensated on high estimates (conflict of interest) had estimates that averaged $22.00.

So, What is The Solution?

Since we can plainly see that the addition of conflict of interest is a recipe for deceit (and disaster for the investor), the only solution to this highly flawed and broken system is to seek out a financial advisor who does not engage or subject himself to the possibility of conflict of interest in any way. This means no commissions.

A Registered Financial Advisor (RIA) or Registered Fiduciary (RF) are held to an entirely different standard than financial planners, financial advisors, wealth managers, and all the other creative titles financial salespeople select for themselves. A Registered Financial Advisor and a Registered Fiduciary are held to the highest standard of care. Legally bound to operate in the best interest of their client, a fiduciary who is "fee based" is the only way for investors to effectively remove themselves from the myriad of smokescreens and games financial advisors play.

The system, as it is, allowing financial advisors to earn a commission by recommending financial products, is completely broken. Obviously this advice will be tainted by the draw of earning a hefty commission. Any trusting investor who believes otherwise is placing themselves in a terribly vulnerable position.

If you are currently using a financial advisor to handle your investments, your first order of business should be to find out how they are compensated. Don't accept verbal information. Get it in writing. If they are not a fiduciary, you probably won't be happy with the answer you receive, but it's better to find out now than after you've suffered huge losses due to hidden fees wrapped up in your investments.

Transparency in the industry. It may happen one day, but for now the responsibility lies with you, the investor. It's your retirement, your financial future. There's no time like now to do some housecleaning and protect what is rightfully yours.