SPARTA: PEEK INSIDE THE BROKER'S KIMONO USING REAL LIFE MATH

Financial advisors sell clients all the time by telling them that 'our interests are aligned.' Is this statement true? Let's examine the math in order to see whether this holds up or not.

Smart investors look at financial incentives because they give powerful insight into human behavior. So let's ask, what are the financial incentives that motivate financial advisors?

99.9% of financial advisors are paid a fee that is calculated based on one variable: AUM (assets under management). Financial advisors like to persuade clients that their interests are "aligned, because when you [the client] make more money, your AUM goes up and our fees go up, so we are incentivized to watch your portfolio like a hawk." On the surface, this is true. However, the statement "our interests are aligned" is totally misleading as the two simple math examples below reveal.

<u>First example</u>: let's say that a financial advisor charges a fee of 1% per year on AUM and he currently makes $100,000 per year. He just got married and has a kid on the way and wants to increase his business so he can make $200,000. What would he need to do to achieve this?

To make $100,000 he needs $10,000,000 in AUM ($10mm x 1% = $100k) -- current
To make $200,000 he needs $20,000,000 in AUM ($10mm x 1% = $200k) -- desired

The Answer: he needs to go out and get $10mm AUM worth of new business. *Question, could he, realistically, increase his income to $200,000 purely by focusing on the performance of his existing clients?* Yes. <u>But it would take him almost 15 years (taking taxes into account) if he made his clients an 8% return, every year, without fail.</u> 15 years is a long time. And usually there are losing periods.

Now, if his average account size were $500,000, then he would need to go out and get 20 new clients. Might take him a year or two but sure beats 15 years! So if you were that broker, would you be focused on getting new business or on risk management and asset allocation? New business!!!

<u>Second example</u>: again, we are investigating the truthfulness of the statement that "our interests are aligned." *<u>Let's see who bears the brunt of the risk when things go south.</u>* If the client's account goes down 20% (which it did for many investors in 2008) and started with $10mm AUM and the financial advisor charges a fee of 1% per annum, here is the math:

Client situation: Client lost 20% (1/5th) of all their capital ($2,000,000 loss). **Pain level: HIGH.**
Financial advisor situation: made $80,000 in profit. No capital loss. **Real world pain level: LOW.**

Conclusion: **the math clearly shows that interests are not aligned on the upside or downside.**

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