

Investing in More Objective Advice

A Guide to Working With an
Independent Registered Investment Advisor

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Introduction

Forty-six percent of wealthy households now use an independent advisory firm as their primary financial relationship because they feel they receive more objective advice.

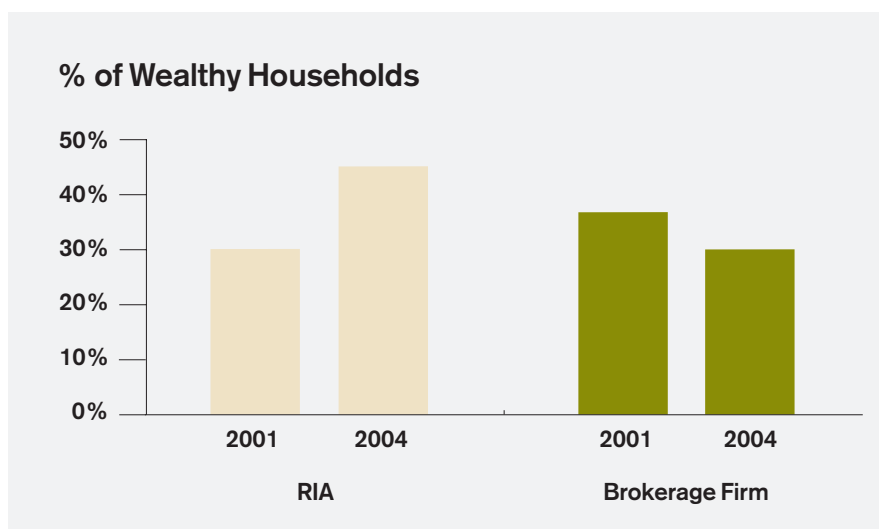
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Source: Spectrem Group, Ultra High Net Worth Perspective Series, Summer 2004.

Finding a qualified financial advisor has never been easy. But today it is more challenging than ever given the myriad financial professionals claiming to offer objective advice.

Fortunately for investors, many highly qualified advisors are leaving brokerage firms behind—along with certain conflicts of interest—and becoming independent Registered Investment Advisors (RIAs).¹ To better serve their clients, these advisors have chosen to operate under a fee-based compensation system that does not compromise the integrity of their advice in the same way the typical broker's advice may be biased when their personal incomes are derived from trading commissions or product sales. The result of this quiet migration toward advisor independence is that some of the nation's most experienced advisors can now be found at private

or boutique firms whose names you've probably never heard of. The thousands of independent advisory firms that dot the nation generally share one important characteristic: a fiduciary responsibility to provide advice and investment recommendations that are in the best interests of their clients.

Advisors who pursue this client-centered business model typically align their own financial interests with those of their clients by basing their fees on services rendered or on a percentage of assets under management, in contrast to the traditional broker business model that rewards brokers for trading activity or product sales. As advisors have moved toward independence, an increasing number of affluent and high-net-worth investors have also made the switch to independent Registered Investment Advisors (see graphic).



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Source: Spectrem Group, Ultra High Net Worth Perspective Series, Summer 2004.
Note: Wire houses include private client assets of Merrill Lynch, Smith Barney and Morgan Stanley

Without a national brand, investors may find it difficult to evaluate the experience, qualifications and trustworthiness of independent RIAs, many of whom spent decades on Wall Street before going independent. This white paper is designed to help you better understand this universe of advisors.

Specifically, this white paper will:

- Help you consider whether an independent financial advisory relationship is right for your needs.
- If the answer is yes, you'll learn how you might go about finding a qualified advisor, including questions to ask and qualifications to look for.
- You'll also find out how to identify your own needs, which should serve as the basis for your selection of an advisor who offers the services you require.
- Additionally, you'll discover how to monitor and evaluate your advisory relationship on an ongoing basis to ensure that it continues to meet your evolving needs.

About Schwab Institutional

Schwab Institutional, a division of Charles Schwab & Co., Inc., member SIPC, has been playing a key role in the growth of independent Registered Investment Advisor (RIA) firms for close to 20 years. By serving as custodian for client assets

managed by independent RIAs, Schwab Institutional offers an infrastructure that helps advisors to be independent while reassuring their clients that their assets are held by a financially strong and secure company. The advisors who work with Schwab Institutional are not employees of the company. Rather, they are typically independent firms that look to Schwab Institutional for important services that enable them to focus on the advisory relationship and better serve their clients.



1 Is It Time for a New Financial Services Relationship?

How do investors know when it's time to take a fresh look at their financial services relationship? In some cases a re-evaluation is called for when the existing advisory relationship is not meeting the investor's needs. Today's affluent investors demand a combination of the following capabilities:

- Investment performance
- Quality service
- Knowledgeable representatives and advisors
- Ability to resolve problems
- Familiarity with their specific situation ²

Communication is also a critical component of the advisory relationship. In addition to proactive phone calls and periodic updates on financial market developments, investors should expect to receive quarterly, comprehensive performance reporting that tells how their investments are doing compared to the appropriate benchmarks.

The role of trust

Above all, an advisory relationship must be based on trust. An extensive survey of more than 6,000 advisory clients conducted by Schwab Institutional revealed that trust was the most important factor in an advisory relationship, followed by competence, quality of advice and investment returns.³

Investors who do not deem their advisors trustworthy are taking their money elsewhere—in fact, one recent survey showed that high-net-worth households that felt trust was lacking in their relationship were one-and-a-half times more likely to move at least some of their business to another advisor.⁴ Similarly, 25% of affluent investors recently surveyed by Spectrem Group moved a portion of their assets out of their financial services firms in the previous two years because of lack of trust.⁵

Growing complexities of personal wealth management

Another reason to consider a new financial advisory relationship is when one's financial affairs have become so complex that the individual or the existing advisor cannot properly manage them.

Triggering factors may include extraordinary income due to an asset sale, executive compensation or business liquidation; asset growth requiring complex tax and portfolio

analysis; retirement concerns such as how to take required minimum distributions or arrange beneficiary designations for minimal tax impact; changes in family dynamics requiring revisions to the estate plan; or the simple realization that something may be missing from the overall financial plan or the relationship with an advisor.

When one's financial affairs become too complex for an individual to manage alone, it sometimes takes a team of advisors to address such areas as investment management, tax planning, risk management, income planning and estate planning in an integrated manner.

Questions to ask yourself

Here are some questions that can help you determine if it might be time for a new financial advisory relationship.

For investors who already work with a broker:

- Do I feel that my broker's advice is based on a thorough understanding of my personal goals, financial situation, life stage and risk tolerance?
- Did my broker and I collaborate to create a customized investment plan that truly reflects my situation?
- Am I satisfied with the frequency and quality of the contact I currently have with my broker?
- Do I sometimes feel that my broker's recommendations for products, including ones from their own company, are not always in my best interest or may be motivated by commissions?
- Does my broker have the expertise and credentials (such as CFP, CFA, CPA, MBA or JD) to advise me about my complete financial situation, including taxes and estate planning?
- Am I confident that the plan I've developed with my broker will help me maintain my lifestyle into retirement and provide for my family after I am gone?
- Has my broker recently reviewed my beneficiary designations with me to make sure the designations on record are the individuals whom I would intend to receive proceeds?

For individuals who are investing on their own:

- Is my portfolio becoming too complex or time-consuming for me to feel comfortable managing on my own?
- Do I have the tools I need to plan and optimize my portfolio to meet my near-term and long-term financial goals?
- Would I rather be spending my time on other things?
- Is my portfolio currently meeting or exceeding my performance goals?
- Does my investing plan take my entire financial picture into account, including investments, assets like real estate or a small business, and debts?
- Would I have more peace of mind if I were working with an investment professional to help me achieve my financial goals?

2 Considering an Independent RIA

Fiduciary:

An individual legally appointed and authorized to hold and manage assets for the benefit of another individual rather than for his or her own profit.

For investors who are dissatisfied with their current brokerage relationship—or are tired of going it alone—the next step is to consider the type of advisor who will help them meet their financial goals.

Investors are increasingly choosing independent firms as their primary financial advisors because they believe they are more objective.⁶ However, it's important for investors to know that in the financial advisory business there are two kinds of advisors often associated with independence: Independent Broker-Dealers (IBDs) and independent Registered Investment Advisors (RIAs). How does an investor know which type of independent advisor is right for them?

How are independent advisors regulated?

One way to understand your options is to consider who regulates each type of advisor. Independent Broker-Dealers are registered with, and regulated by, the National Association of Securities Dealers (NASD). Although some IBDs operate fee-based businesses, their NASD securities licenses allow them to charge commissions on securities transactions and product sales, and most do. These advisors may operate under an independent firm name such as Joe Smith Financial Services. This, by itself, won't tell you whether the advisor is an IBD or independent RIA. However, if they are affiliated

with an Independent Broker-Dealer, their brochure or business card will say "Securities offered through ____." This may indicate a focus on securities or product sales rather than advice.

By contrast, independent Registered Investment Advisors are registered with the Securities and Exchange Commission (SEC) or their state securities regulator. They are regulated by the Investment Advisors Act of 1940, which means they have a **fiduciary** duty to act in the best interests of their clients. Most RIAs are independent firms, which means the business owners are their own proprietors; they are not employees or agents of a large financial institution. Independent RIAs generally charge a fee for their services rather than commissions on the sale of investment products. For clients, that puts advice, as opposed to investment products, at the center of the advisory relationship.⁷

How do independent RIAs charge for their services?

Fee structures vary among independent RIA firms; most charge asset-based fees that align their interests with those of the investor: As the account size grows, so does the advisor's compensation. However, some independent RIAs are beginning to design alternative fee structures to accommodate client needs; these may include fees for financial plans, annual or retainer fees, and hourly fees. Regardless of

how they charge, independent RIAs are obligated under the Investment Advisors Act of 1940 to disclose all fee arrangements in advance.

What services do independent RIAs provide?

Investment advisory practices typically fall into two groups: money management and financial planning. In recent years a third group has evolved in response to the complex needs of high-net-worth individuals and families: wealth management. However, most advisors offer combinations of services. When searching for a financial advisor, it is important to know which type of service you need.

Money management

Money management focuses on the investment portfolio. Money managers:

- Design portfolios that comprise individual securities, bonds, real estate or other financial assets.
- Often manage the portfolio on a discretionary basis.
- Typically charge fees based on a percentage of the value of the assets under management.⁸
- May hold the Chartered Financial Analyst® or CFA® designation. This means they have met the rigorous experience, education, examination and ethics requirements established by the CFA Institute, a nonprofit organization that monitors

professional standards for investment management.

Financial planning

Financial planning looks at investments within the context of a client’s total financial picture. Financial planners:

- Help you look to the future and do long-term planning in the areas of retirement, college funding, wealth transfer, tax planning and insurance.
- May hold a planning designation such as Certified Financial Planner (CFP), or other designation, which means they have met specific education, examination and experience requirements and have agreed to adhere to high standards of ethical conduct.⁹

Advisors who provide...	might typically say...
Money Management	“We’ll create an investment strategy and manage your money for you.”
Financial Planning	“We’ll create a comprehensive financial plan and implement that plan by managing and monitoring your money.”
Wealth Management	“We’ll create a customized, comprehensive plan to address your financial needs. We’ll manage all aspects of implementing that plan, including offering expertise on estate planning needs and tax-sensitive considerations.”

Incidentally, CFA charter holders and CFP licensees can be affiliated with full-commission brokerage firms, Independent Broker-Dealers or independent RIA firms. A designation by itself does not tell you if the advisor will be acting as a fiduciary. So, while designations such as CFA or CFP are helpful in assessing the experience and qualifications of an advisor, the advisor's status as an independent RIA is what ultimately defines the fiduciary obligation.

Wealth management

Wealth management includes a broad range of services geared to high-net-worth individuals and families. Firms that provide holistic wealth management services have specialist teams that provide services in the areas of:

- Investment management
- Financial planning
- Cash flow optimization
- Retirement planning
- Liquidity/restricted stock
- Risk/liability management
- Insurance
- Personal and business lending
- Trusts and estates
- Wealth transfers
- Philanthropy/charitable giving
- Business succession planning
- Tax guidance.¹⁰

Most true wealth management firms are independent advisors

acting in a fiduciary capacity. But investors should also be aware that “wealth management” has become an industry buzzword, and there are many “wealth managers” who are actually salespeople masquerading as advisors.¹¹

Questions to ask yourself

Before interviewing financial advisors, it's important for you to know which services you need.

Ask yourself:

- Am I looking for someone primarily to manage my investment portfolio?
Consider an advisor who specializes in money management.
- Do I need someone to review my overall financial situation, including investments, taxes, insurance, retirement plans and estate planning?
Consider an advisor who focuses on financial planning.
- Is my net worth more than \$1 million and do I need highly specialized services delivered through an advisory team?
Consider a wealth management firm.

Spectrum of Independence

Fully Affiliated

Fully Independent

Full-Commission Brokers

- Offer investment services, proprietary (in-house) products and outside products such as mutual funds and annuities; may offer financial planning services
- Brokers' firms may also offer investment banking services which may conflict with best interests of individual investor clients
- Brokers' firms often set production goals, or revenue targets, and may offer incentives to brokers who sell proprietary products
- Primarily commission-based; some fee-based business
- Technical term for brokers is "registered representative"; also called financial advisors, financial consultants or investment consultants

Independent Broker-Dealers

- Are generally free to run their business the way they want (i.e., less pressure to sell proprietary products), but receive some services from a larger firm
- Emphasis is on investment products: managed accounts, annuities, mutual funds, insurance
- May charge commissions and/or fees; may be under less pressure to generate revenues for the firm compared to full-commission brokers

Registered Investment Advisors

- Emphasize advice, not products
- Services vary depending on expertise and focus of firm—may be money management, financial planning, wealth management or some combination
- Trading and custody services provided by unaffiliated firms such as Schwab Institutional
- Generally charge fees, not commissions
- May legally call themselves "investment advisors"

Investment Advisors Act of 1940

"Investment advisor" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities. Does not include any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer.

Under the Act, investment advisors are required to:

- **Act in the best interest of the firm's clients**
- **Fully disclose all fees associated with their services and how these fees are charged**
- **Fully disclose whether the firm or an employee of the firm has an affiliation with any other securities professional, such as a stockbroker**
- **Fully disclose any facts that might cause the firm to render advice that is not "disinterested"**

3 Interviewing and Selecting an Independent RIA

Form ADV:

A form that is kept on file with the Securities and Exchange Commission that contains critical financial information about an independent Registered Investment Advisor (RIA). Part I of Form ADV provides information about the advisor's education, business and disciplinary history within the last 10 years. Part I is filed electronically and can be found online at the SEC's Investment Advisor Public Disclosure website (www.adviserinfo.sec.gov). Part II provides information on an advisor's services, fees and investment strategies. The SEC does not require advisors to file Part II electronically, but advisors are required to give you Part II at the first meeting. You may also ask the advisor for Part I if you prefer not to access it online.

The one professional responsibility that all independent RIAs have in common is a fiduciary duty to act in the best interests of their clients. Beyond that, their offerings and capabilities can vary widely. You'll want to shop carefully to find a firm that offers the services you need and that you believe has the competence to deliver them.

Step 1: Gather information

Independent RIAs are required to furnish pertinent information on **Form ADV** when they register with the SEC or their state securities administrator. (Firms that manage more than \$25 million in assets register with the SEC; those that manage less than \$25 million generally register with their state securities administrator.)

Step 2: Know your investment objectives

To choose the right advisor, you must understand what you expect from the relationship. This includes understanding your investment objectives. Identifying your objectives will help prepare you for your interviews and for the relationship itself because advisors will need to know these things about you in order to best serve you.

- ◆ **Investment goals**
Identify any specific goals you're working toward, such as legacy or philanthropic goals.
- ◆ **Risk tolerance**
Investments that have the

potential to generate higher returns generally fluctuate more in value. Consider how much fluctuation you are willing to tolerate in exchange for the opportunity to earn above-average returns.

- ◆ **Time horizon**
How long do you expect to leave the assets invested?
- ◆ **Income needs**
Will you be drawing income from your portfolio? How much income will you need?
- ◆ **Liquidity**
How soon will you need to convert your investments into cash for spending or other purposes?
- ◆ **Tax situation**
Are you in a high tax bracket? Are you investing assets in a taxable or tax-deferred account such as an IRA rollover?
- ◆ **Other holdings**
In addition to your investable assets, do you have a significant amount of wealth tied up in a business, real estate or other illiquid assets?
- ◆ **Other needs**
Do you have complex planning needs related to wealth transfer, executive compensation, risk management, business succession planning or philanthropic planning?

Step 3: Prepare a list of interview questions

Next, prepare a list of interview questions for the advisors you meet with. Here are some of the questions you might ask when hiring any financial professional:

◆ **What types of services do you offer?**

Services may include financial planning, investment management and other related services.

◆ **Do you hold any professional designations?**

Professional designations indicate differing levels of education, experience and achievement.

◆ **What size is your firm and how many clients do you have?**

Practice size is indicated by number of employees, assets under management, average portfolio size and number of clients. Larger firms may have more resources; smaller firms may offer more personalized attention.

◆ **What is your management style and philosophy?**

How does the advisor choose investments? How often does the advisor adjust portfolios? Will the advisor prepare a written plan?

◆ **How are you compensated?**

Fee-based advisors may charge a percentage of assets managed (typically 1%) or an hourly or flat fee according to account size and services offered. Note: Fee-based advisors may receive commissions for recommending certain products, such as insurance policies or annuities; fee-only advisors do not charge commissions.

Visit these websites to check the background of a specific advisory practice:

- **North American Securities Administrators Association:**
www.nasaa.org
- **CFA Institute:**
www.cfainstitute.org
- **Certified Financial Planner Board of Standards:**
www.cfp-board.org
- **National Association of Personal Financial Advisors:**
www.napfa.org

◆ **How will I be billed?**

Typically, asset-based fees are billed quarterly and financial planning services are billed by the hour.

◆ **Who will I work with, and how will I work with your firm on an ongoing basis?**

Determine if you will work with the person you are interviewing or if another associate at their firm will actually manage your portfolio. Ask how many clients they manage.

Ask how often and in what format you will have contact with your advisor between formal portfolio reviews (e.g., monthly at first, streamlining to quarterly once you are underway? Via phone or in person?).

◆ **What is your expertise?**

What is your investment methodology?

Advisors often specialize in investment strategies that can include specific investment vehicles (such as mutual funds, stocks and bonds, etc.) and styles such as large-cap, small-cap and international. Determine the advisor's knowledge about your area of interest and that his or her methodology or style aligns with your objectives.

◆ **Describe your buy and sell strategy for investments**

The advisor should be able

to articulate an investment methodology that guides decision-making for both buy and sell strategies.

◆ **What is your record with clients who share my investment needs and risk tolerance?**

While past performance does not guarantee future results, ask to see performance numbers on portfolios similar to yours in both up and down markets, and compare them with relevant benchmarks, such as the S&P 500®, during the same period.

◆ **Can you provide references?**

An advisor should be able to provide you with the names and contact information for three current clients. You may also request contact information for professional references such as his or her banker, lawyer and CPA.

A note on professional designations...

Investment advisors and financial planners may come from many different educational and professional backgrounds. Before you hire a financial professional, be sure to ask about his or her background. If he or she has a credential, ask him or her what it means and what he or she had to do to earn it. Also find out which organization issued the credential, and then contact the organization to verify whether the professional you're considering did, in fact, earn the credential and whether the professional remains in good standing with the organization. For information on various financial professional credentials and the entities that issue them, please visit NASD's website at www.nasd.com and read "Understanding Financial Professional Designations."

4

Establishing a Relationship and Monitoring Performance

Discretionary Account:

An account that allows an advisor to buy and sell securities on behalf of a client, typically in accordance with the parameters of an investment policy that is jointly created by the advisor and the client.

The relationship you build with your financial advisor is one of the most important relationships you'll ever have. You'll be disclosing personal information about your finances, your family, your goals and your worries and concerns about money. And you'll be placing trust in your advisor to guide you and help you make important decisions throughout your life. Ideally, the relationship will span many, many years—and perhaps even into the next generation. It is therefore not a relationship to enter into lightly. Choosing the right advisor and helping the advisor understand your needs can help the relationship get off to a good start.

Communicating your needs

Your advisor will need to know a great deal about you in order to properly advise you. Full disclosure on both sides—what you're looking for from the advisor and what the advisor is prepared to do for you—is crucial to the relationship. The more the advisor knows about your finances, the better he or she can guide you. The advisor may ask you to provide copies of some or all of the following:

- Bank and brokerage statements
- Mutual fund and annuity statements
- Recent tax returns
- Insurance policies
- Wills and trust documents

The advisor should also ask you lots of questions in order to gauge your risk tolerance, time horizon and other investment objectives. You may be asked about previous investing experience and any preferences you may have, such as certain stocks or investment categories you wish to avoid. Although the questions may seem very personal at times, rest assured that all this probing is in your best interests. And for independent RIAs it's required by law: The advisor has a fiduciary responsibility to know you as an individual and understand your needs before making recommendations.

Implementing the plan

The advisor will recommend a course of action and obtain your approval before proceeding. This is your opportunity to ask questions and fully understand the nature of the recommendations, the reasons behind them and the outcome you can reasonably expect. To provide better service, your advisor may prefer to manage your account on a **discretionary** basis. This means you and the advisor together would decide on an overall strategy, referred to as the investment policy statement, with the day-to-day execution performed by the advisor. This arrangement works well for many investors, allowing the advisor to capitalize quickly on opportunities in the market as they arise.

Monitoring performance

Your advisor should provide you with trade confirmations, account statements and performance monitors that show trading activity and investment returns in relation to the appropriate benchmarks. These performance reports should show investment performance on a year-to-date or program-to-date basis so you know exactly how your investments are doing. If your current advisor does not provide these, this may be a reason in itself to switch advisors.

Ten steps the NASD recommends that investors take when monitoring their investments:

1. Read and keep all documents that you receive from your broker, mutual fund or investment advisor. Check to make sure your confirmations and account statements are accurate.
2. Keep good notes of communications with your broker or advisor.
3. Get all confirmations and account statements sent directly to you or to someone you trust such as a family member, lawyer or accountant.
4. If you don't receive account statements or confirmations, follow up.
5. Ask questions about any information you don't understand.

6. Consider getting online access to your account so you can review it whenever you want.
7. Do not make checks or other payments payable to an individual; money should only be sent to your brokerage firm, its clearing firm or another financial institution.
8. Meet with your broker and visit the firm, if possible. Investments are a major financial undertaking and should be afforded the same degree of investigation and caution as any other major purchase you might make.
9. Conduct independent research on your investments. Ideally, you should independently verify information by thoroughly reading prospectuses, research reports, offering materials and annual reports.
10. Periodically review your portfolio. Make sure the securities in your account still meet your investment objectives. Also, make sure you understand and are comfortable with the risks, costs and liquidity of your investments.

Source: National Association of Securities Dealers.

5 Conclusion

At one time it was believed that the major Wall Street brokerage firms offered the ultimate service when it came to comprehensive investment information and advice. But today, independent RIA firms are the leading primary provider of advice to affluent investors and are staffed with some of the nation's most qualified professionals.

As investors become aware of their need for a new advisory relationship—either because they are dissatisfied with their current brokers or they seek a higher level of professional advice—they are increasingly turning to independent RIAs whose interests are aligned with their own. These firms are

steadily attracting investors in search of competent service, suitable investments and more objective advice.

Many independent RIAs now work for boutique firms with little national name recognition, and that creates a challenge for investors seeking a new type of relationship and an advisor who is qualified to provide the services they need. But by understanding the options and following a disciplined selection process, investors can position themselves to identify an appropriate advisor who can help with the long-term management of their financial affairs.

Notes

¹ "Refugees Have Less Money, Clear Conscience," *Investment News*, March 14, 2005.

² NFO World Group, "Affluent Market Research Program," October 2002, \$1M+ Investable Assets.

³ "The Real Target," *Investment Advisor*, September 2005.

⁴ "Centering on Trust: Profiting from Trusted Advisory Relationships," *The VIP Forum*, 2004.

⁵ "Key Strategies for Building Optimal Client Relationships," *Schwab Institutional and Moss Adams*, 2005

⁶ *The VIP Forum*, May 2004.

⁷ "Tracking the Trendy," *On Wall Street*, September 2005.

⁸ "Financial Professionals," *Certified Financial Planner Board of Standards*.

⁹ *Ibid.*

¹⁰ "Centering on Trust: Profiting from Trusted Advisory Relationships," *The VIP Forum*, 2004.

¹¹ "The Wonderful World of Wealth Management," *Financial Planning*, May 2004.

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