FINANCIAL ADVICE

Is Hiring an Advisor 'Worth It'?

A key consideration: How many parts of your financial life can the advisor impact for the better?

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“Can advisors add enough value to justify their fees?”

That was the provocative question posed by a reader recently in an email. He noted that most of his friends with financial advisors seemed to be satisfied with their experiences. But he considers himself a sophisticated individual investor; would an advisor add enough to his bottom line to offset the fees?

The answer is, of course, it depends. But what exactly does it depend on? To my mind, there are five key factors, some of them easy to quantify and others a lot squishier.

1) The level of fees. In the category of easier to quantify: How--and how much--is the advisor charging for services? That's obviously the hurdle the advisor's services will have to overcome to make the engagement worthwhile. For that reason, it's mission-critical that anyone who's considering hiring an advisor understand how that person is charging for services and translate that into dollars and cents. If an advisor is charging a percentage of assets annually, a recurring subscription fee, or a per engagement or hourly fee, it's easy to come up with a total annual dollar outlay. (If you're paying hourly or per engagement, however, remember that expense may not recur from year to year.) If the advisor is charging in some other way, such as by putting you in commission-based products, your total outlay may be more opaque. There's no single "right" way to pay for financial advice; this article compares and contrasts the different ways that advisors can charge and suggests the type of clients each arrangement is most appropriate for.

2) The breadth of advice on offer. This is a huge swing factor. Advisors tend to fall into one of three buckets: Those whose primary focus is managing a client's investment portfolio, those who focus primarily on financial planning, and those who emphasize both areas. An advisor who's exclusively or primarily focused on your investment portfolio will tend to have fewer opportunities to add value than one who is focused on your investment portfolio and matters such as budgeting, retirement planning, and insurance. The more touchpoints the advisor has into your financial life, the more opportunities he will have to overcome his fees. On the other hand, the level of fees may be higher to begin with if the advisor is offering comprehensive financial and portfolio planning, which is why it's so important to understand how and what you're paying.

In their research paper, "Alpha, Beta, and Now...Gamma," Morningstar's David Blanchett and Paul Kaplan attempted to quantify how much value advisors can add with services other than asset allocation and security selection: tax-efficient asset allocation, adjusting withdrawal rates to account for life expectancy and market performance, and assisting with the decision about whether to purchase an annuity. Their research demonstrated that a retirement plan that encompasses these "gamma" factors was able to generate an income level that was more than 20% higher than a retirement plan that didn't incorporate the gamma factors. Of course, the specific benefit derived from any specific financial plan will vary from individual to individual and will be very difficult to quantify in any case.

3) The advisor's skill level. It's pretty intuitive that an advisor offering a broader range of services will have more opportunities to add value than one with a narrower focus. Trouble is, many if not most advisors today say they offer a broad range of financial planning services. Given that, how do you sort among them to know which ones are truly skilled in a gamut of areas and which ones are merely paying lip service to the idea of being holistic and comprehensive? Here, larger firms may offer an advantage in that they might have a broad range of experts on staff, including tax specialists, investment experts, estate planners, and so forth. If you're attracted to the idea of a smaller firm or a solo practitioner rather than a big shop, the certified financial planner credential is a signal that the advisor has completed and been tested on a course of study that touches on a broad range of financial planning issues.

4) The investor's skill level. A related question is, How well would the investor do on her own, without the aid of the advisor? That comes down to how educated the investor is about investments as well as financial planning. If the answer is not at all, the advisor would have more room to add value above and beyond what the investor might do on her own. On the other hand, if the investor is very investment- and planning-savvy, hiring an advisor may provide less of a benefit.

Be sure to keep a couple of things in mind when making a self-assessment. First, it's human nature to overrate our attributes, whether our appearances or our driving abilities; at least some of us are apt to overrate our financial acumen as well. In other words, it's possible you're not as good at this stuff as you think you are. In addition, upon self-reflection you may decide that you're knowledgeable about some aspects of the financial planning process, such as investments, but that you have blind spots in other areas, such as tax planning. If that describes you, it might make sense to pick off financial advice with an advisor who specializes in your weak spot and charges on an hourly or per-engagement basis.

Finally, remember that there can be a disconnect between knowledge and action. Investors who know better still do dumb things with their money, whether living beyond their means or making emotional investment decisions. If, after a thorough accounting, you know you’ve made lots of financial decisions you later regretted, you may derive a huge benefit from hiring an advisor who will help you enact change. Indeed, many advisors say they add as much if not more value as behavioral coaches than they do by providing nitty-gritty financial planning guidance.

5) Life stage. Last but not least, life stage is an important consideration when deciding whether hiring a financial advisor can add value for you. While solid financial advice can be incredibly valuable early in life to ensure that a plan gets off on a solid footing, it's arguably even more important for older adults. While older adults are often topnotch investors because they have a lot of experience under their belts, my view is that they, perhaps more than anyone, have a need for a second set of eyes on their plans. For one thing, retirement portfolio planning is inherently more complicated than portfolio planning during our accumulation years. In addition, cognitive decline is a risk factor as we age. My dad experienced dementia later in life, and I was glad I could be there to serve as his financial manager. But if you don't have a trusted adult child waiting in the wings to take over when necessary, or if you decide you're just not enjoying it anymore, finding an advisor you trust is a prudent step.