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How to find the right financial adviser

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The Globe and Mail has published several insightful articles on how to invest successfully in stocks. However, most people would prefer to leave that to someone else. Which raises the question: Just how should you go about finding the best person or firm to invest your family's money?

Let's start by putting the question in context. Over any period of more than a year, most active investment managers will, after fees, underperform the broader market. This is true on a before-tax basis – and doubly true after tax. So finding that rare manager who can beat the market over time is not only an important task, but a difficult one.

To assist you in your quest, here are some suggestions.

Comfort and trust
It is, of course, crucial that you deal with someone with whom you feel comfortable talking about your financial affairs, and in whom you have complete trust. That person will focus on your circumstances and goals, not their product.

In addition to trusting your instincts as to whether the person or firm is truly putting your interest first, it is a good idea to inquire about their reputation. Ask to speak to an existing client of the firm about their experience.

The majority of Canadian investment management firms have high standards, but there are some dramatic exceptions.

Understandable investment approach
Naturally, you will inquire about the firm's long-term investment returns. (The key here is "long term.") The investment strategy should be proven to work over time, particularly in down markets. Equally important, the investment approach should be easily understood. This test eliminates a surprisingly large number of investment firms, including the large, diversified financial institutions that have lots of products on their shelf but no underlying philosophy.

You should also ask how decisions are made. Is it by an individual who could leave tomorrow, or does the firm have a disciplined and repeatable process implemented by a qualified team? You should, of course, know exactly which securities you own at all times. If the firm operates a "black box" into which you are not permitted to see, thank them for their time and move on.

A reasonably focused portfolio
Most investment accounts are overdiversified. To quote Warren Buffett, "Diversification is protection against ignorance. It makes little sense if you know what you are doing." Independent studies have shown that the more stocks in a managed portfolio, the less chance it will, after fees, outperform the broader market. Some diversification is a good thing, but 20 high-quality companies operating in at least five industries is sufficient.

Alignment

To ensure your manager is fully focused on maximizing your investment returns, and has the same risk profile as you, the manager should have most of their financial capital invested in the same portfolio as you do. Be sure to ask about this.

Reasonable fees
The firm should disclose exactly what fees they will charge, and those fees should be reasonable for the amount managed. It is stunning that the vast majority of clients have no idea what fees they are paying. This is crazy. All studies prove that, over time, investment returns vary inversely with the amount of fees charged. Some investment managers have been known to say, "You get what you pay for." A more accurate statement would be, "We get what you pay for."

The most egregious fees are so-called performance fees, which consist of the investment firm taking a percentage of the return in a given period above a hurdle rate. At first blush this seems quite reasonable, but typically the performance is measured over too short a period on which to judge – let alone reward – investment success. Very few people realize that, in most years, the stock market either rises more than 20 per cent or produces a negative return. Irrespective of your money manager, your return will be strongly correlated with the return of the broader stock market. If your manager charges a performance fee and your portfolio rises sharply with the broader market, you will be obliged to pay a hefty additional fee. If the market, along with your portfolio, tanks the following year, the manager will not return that fee.

A further problem with performance fees is that the investment firm has an incentive to take additional risk with your money. Rolling the dice results in a big payday for the firm if it works out, while you are left with the loss if it doesn't.

Tax efficiency
Last, but not least, look for a firm that recognizes you live in an after-tax world. Like fees, taxes erode your capital over time. You pay capital gains tax only when an investment is sold. So there is a great advantage in finding a manager with low portfolio turnover. This allows your money to compound on a before-tax basis. One test of whether an adviser truly puts your interests first is whether they focus on, and talk to you about, your likely long-term after-tax returns.

Selecting the right investment manager will make a huge difference to your ability to retire comfortably. Your single best investment may be the time you spend making that selection.

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