

Why Hire an Investment Consultant?

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There are many investment terms that are tossed about which can be confusing to a typical investor. I have been reminded recently that a seemingly simple term, “Investment Advisor,” can mean different things to different people. Professionals in our industry use labels such as Investment Advisor, Financial Planner, Financial Advisor, Financial Consultant, and Investment Manager to try to neatly describe what they do for a living. Often, a client misunderstands the label or believes that all investment professionals provide the same service.

With this article, I would like to distinguish between two labels: Investment Manager and Investment Consultant. Firms in either category are likely to be considered “Registered Investment Advisors” under the jurisdiction of the Securities & Exchange Commission or their respective state securities department. The investment advisor label can be very broad, and investors seeking to employ an advisor must be clear about the services they will be receiving. Often decisions to hire an advisor are made based on quoted fees...it is important to understand what services are being provided for the quoted fee level and to understand why one firm’s fees may be lower or higher than another.

Investment management firms “manage” portfolios for their clients, and have the discretion to buy and sell securities as they determine most appropriate based on their philosophy and methodology. By taking discretion over the portfolio, investment managers are not required to receive approval from their clients in order to make trades in the portfolio. The methodology used by these investment managers (also referred to as “money managers”) are reflective of their “style” of investing. For example, a “value style” stock portfolio manager may consider the price/earnings ratio, price/sales ratio, dividend yield and other metrics to determine if a stock is undervalued relative to its current market price...they are looking for a good “value” when purchasing a stock. A “growth style” stock portfolio manager may consider forecasted increases in sales or earnings when purchasing a stock, regardless of its current market price. There is no right or wrong with either style, and there are many successful managers that have used both styles.

By hiring a single investment manager, an investor’s returns will be entirely dependent on how that manager is able to perform. The performance of any single manager is highly dependent on the style employed, and whether or not that style is “in favor” during any particular time period. For example, growth style managers generally outperformed value style managers in the late 1990’s, but value managers outperformed growth managers in the early years of this decade.

Conversely, an investment consultant does not “manage” portfolios, nor does a consultant typically have discretion over the activity in client accounts. A true consultant develops very specific investment strategies according to a detailed assessment of each client’s attitudes toward risk, income needs, time horizon, anticipated cash flows, tax considerations (if a taxable account), and other factors based on client-specific situations. The strategy is customized according to client objectives, rather than the consultant’s philosophy or style.

After an investment consultant develops an appropriate strategy for a client, it would then search for the investment management firms to manage each portion of the strategy. Typically, a consultant's search may result in 5-10 different investment managers for a client's portfolio...each one specializing in the specific asset classes (i.e. stocks, bonds, real estate, commodities, cash) that comprise the client's strategy. An investment consultant would conduct manager searches using sophisticated screening and performance measurement analysis to find the most appropriate managers for the client. In addition to quantitative performance measurement analysis, consultants would also review qualitative factors such as an assessment of the manager's organization, personnel, assets under management, regulatory history, etc.

An investment consulting firm is typically retained to monitor the performance of each investment manager in a client's portfolio, most commonly on a quarterly basis. Investment manager returns are compared to the performance of established benchmarks and peer groups of like managers, in order to determine relative performance in addition to absolute performance. Absolute returns are fairly easy for any investor to see, but relative performance often provides a better indicator of the reasons for good or bad returns. By measuring the performance of each manager and understanding the reasons for such performance, an independent consultant can objectively recommend that the manager continue to be retained by the client or that the manager should be replaced. Using this approach, any single manager can be replaced without disrupting the rest of the client's portfolio.

An investment consultant must be truly unbiased with recommendations of money managers to its clients, and must be able to clearly provide conflict-free advice. Advisors who work for firms that also offer investment management services are not truly client consultants, as it is extremely difficult for them to not be conflicted with their recommendations.

The fees charged to clients vary between investment management firms and investment consulting firms. It is very common for an investment manager to charge an annual fee based on a percentage of client assets managed. Investors may hire managers via multiple investment "products," including a mutual fund or a separately-managed account. Annual investment management fees may range from as low as 0.05% for passively-managed products (such as mutual funds that mirror a market index) to upwards of 3.0% for actively-managed products (such as emerging markets stock funds). Some investment managers offer products that charge performance-based fees in addition to annual management fees. Asset-based or performance-based charges are appropriate, as both fee structures incent money managers for good performance.

The fees charged by investment consulting firms may be based on an hourly rate, a flat-dollar fee, or an asset-based fee depending on the services performed for each client. True investment consulting firms do not accept commissions from any money management firm in order to avoid conflicts of interest. The consultant's fee is separate and distinct from the investment managers' fees. An independent investment consultant can often negotiate management fees on behalf of its client, or can screen for the lowest cost investment products. It is possible to retain investment managers and an investment consultant for a combined fee that is less than dealing directly with an investment management firm.

In the end, an investor pays an investment management firm for performance and pays an investment consulting firm for client-specific services provided, such as strategy development, manager searches, performance measurement and evaluation, and reporting. A true consultant provides independent, objective advice and serves as a financial advocate for the client. In the ideal scenario, the investment managers and investment consultant are not adversaries, nor competitors, but work together to deliver a positive outcome for the client. Many of the very best investment management firms make no attempt to staff for client-specific situations, but rather they focus on the execution of their investment strategy and philosophy. Therefore, they are very willing to work with client consultants.

By retaining an investment consultant, an investor would likely have a very well-diversified portfolio with multiple money managers in multiple asset classes. The approach used by independent investment consultants should provide clients with complete transparency of fees and portfolio holdings, with the knowledge and understanding of portfolio performance...rather than a blind dependence on a single money manager. An investment consulting firm has a fiduciary duty to act in the best interest of its clients, and is solely compensated by client fees...not commissions or incentive bonuses from money managers.

According to *The Committee for the Fiduciary Standard*, there are five core principals of the authentic fiduciary standard. I have added context to each of these principals:

- 1) **Put the client's best interest first** – be an advocate for the client.
- 2) **Act with prudence; that is, with the skill, care, diligence and good judgment of a professional** – advice must be based on sound principals and extensive research.
- 3) **Do not mislead clients; provide conspicuous, full and fair disclosure of all important facts** – provide written documentation for all recommendations.
- 4) **Avoid conflicts of interest** – do not accept compensation from any investment management firm, or any source other than clients.
- 5) **Fully disclose and fairly manage, in the client's favor, unavoidable conflicts** – an advance discussion of any potential unavoidable conflicts is important.

There have been many recent, and well-publicized, charges of fraud against investment managers and other financial intermediaries. By retaining an independent investment consultant, an investor improves (but, of course, does not eliminate) the odds of avoiding such situations. Caveat emptor!

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Endnotes:

According to the Committee for the Fiduciary Standard, the authentic fiduciary standard refers to the well-developed body of fiduciary law established by the Advisers Act and other laws and regulations.