Looking for Abraham Flexner

Today's investors must demand higher standards from their financial advisers

BY LANE STEINBERGER, CFP, CFA

A century ago, most surgeons secured their education from one of 155 small, for-profit trade schools where they were taught by part-time doctors, not professors. Minimal regulations guided the curriculum at these schools.

Encouraged by the American Medical Association (AMA) and backed with funding from the Carnegie Foundation, Abraham Flexner published a report in 1910 about the quality of education in America's medical schools. The Flexner Report was an indictment of the medical education system and called on schools to enact higher admission and graduation standards.

In the wake of the report, most of the schools shut down, and the number of medical graduates dropped by half. Today, a prospective doctor completes at least six to eight years of postsecondary education at an AMA-approved institution with full-time clinical professors. In addition, prospective doctors must pass a rigorous state board exam before practicing legally.

At the beginning of the last century, Americans rightly demanded that those who provide their health care meet the highest educational standards. But a decade into the 21st century, American investors have yet to demand the same from those who give them advice about their money.

Indeed, standards are hardly high. To sell financial products, a person has only to pass a two-hour exam that covers basic investment products and laws. There are no educational requirements to become a financial adviser—not even a college degree.

Granted, many brilliant and successful people have no formal education. But would any of us accept legal advice from someone without a law degree? Would we want someone other than a CPA to advise us on complex tax issues? Lawyers usually complete at least three years of law school before sitting for their respective state board exams, and CPAs must complete a 150-credit college degree program.

Although most Americans would be uncomfortable accepting legal or tax advice from a person without a high degree of formal training and education, many of us seem to have a more cavalier attitude about the people we go to for financial advice. And this casual attitude has not produced positive results.

According to a 2009 DALBAR study, "Quantitative Analysis of Investor Behavior," the average individual investor earns about 7 percent less per year than the market. Given an army of financial advisers out there, how is this happening? With more than 1 million people in the United States licensed to dispense advice on investments, shouldn't these returns be better?

In short, today's financial industry is similar to the medical industry in the early 20th century, using methods that lack a rigorous basis and focusing on profit rather than skill. The financial services industry needs an Abraham Flexner of its own, someone to lead the charge to recommend critical and immediate changes to the investment industry.

Some may argue that this proposal is another way for government to impose more rules and restrictions on an already heavily regulated industry. Naysayers had a similar response in the 1930s and 1940s with the establishment of the U.S. Securities and Exchange Commission (SEC) under the Securities Act of 1933 and the development of standards for investment advisers with the Investment Advisers Act of 1940. These two acts improved credibility for the industry, although not all unscrupulous advisers have moved on.

It's time to take the next series of steps to improve the intellectual standards of practitioners in our industry and transform the typical financial adviser from one with a sales product in mind to one with a particular investor's portfolio in mind.

Consider the low barriers in the mortgage industry—similar to financial services, whereby a simple licensing test is the main requirement to participate as a broker. Again, no one would seriously argue against the need for increased regulation and oversight in that industry. Even Alan Greenspan admitted to the House Committee on Oversight and Government Reform in 2008 that the oversight failures in this area were among his biggest mistakes.

The ease of entry into the mortgage industry was highlighted in Darrin Seppinni's 2007 book *The Millionaire Mortgage Broker: How to Start, Operate, and Manage a*

Successful Mortgage Company. Seppinni profiled Mark Shippee, who went from a US$48,000 annual salary driving a Pepsi truck to becoming a mortgage broker and earning more than US$480,000 a year. MortgageDaily.com quoted Leif Thomsen, mortgage millionaire and president of Mortgage Master (one of the largest independent mortgage lenders), as saying, "There is no other business you can come into without an education and make good money." Thomsen obviously never tried to become a financial adviser.

It's time to take the next series of steps to improve the intellectual standards of practitioners in our industry and transform the typical financial adviser from one with a sales product in mind to one with a particular investor's portfolio in mind.

Financial advisers should be required to have a CFA designation or hold a graduate degree in finance to sign off on investment recommendations. The CFA designation requires successful completion of three difficult exams that cover everything from building optimal investment portfolios to determining the option-adjusted spread of a mortgage-backed security using probability trees. Unlike the current tests in many states, the CFA exams focus on economics, portfolio management, accounting, derivatives, and statistics.

Having a CFA charterholder build a customized portfolio for all individual investors may not be practical, but every firm should have a charterholder or comparable expert on staff to assure accountability. For some firms, hiring someone with the necessary knowledge and expertise may raise costs in the short run, but the benefits may include reduced client turnover and higher investment returns, thus producing higher revenue for the firm.

I have found that nearly every financial adviser I know has the Morningstar Principia software on his or her desktop. Many advisers' investment strategies involve screening the entire universe of mutual funds based on the Morningstar rating system. Thus, the fund with the most stars is immediately added to their buy list. This strategy is destined to fail because, in many cases, a highly ranked fund will be at the bottom of the list within five years, according to Dimensional Fund Advisors data.

Although not all CFA charterholders subscribe to modern portfolio theory, research indicates that asset allocation accounts for more than 90 percent of a portfolio's return.*

Chasing performance isn't even good business. Failing to build a well-allocated portfolio that minimizes risk and maximizes return will increase the likelihood of disappointing performance, leading to higher client turnover and lower fee revenue. Of course, investment returns are not the only factor in client turnover, which is why many advisers focus more on personal relationships. But the relationship-based approach is primarily reserved for high-net-worth clients and won't help the average investor who barely has enough to retire.

Consumers have to do their part by making healthy contributions to their nest eggs, but investors should also expect more from those dispensing investment advice.

What role should investment professionals play in bringing about the necessary changes? Today, as a result of of the AMA's efforts, patients are confident that doctors and surgeons have been adequately trained. When was the last time you scrutinized your doctor's academic background? Besides a quick glance at a diploma on the way out, probably never. That's because we know that requirements are demanding for anyone who wants to be a member of this elite profession.

By following the example of Abraham Flexner, investment professionals might achieve similar results in the financial industry. And we need to earn the respect of investors now more than ever.

Many investors in 2010 have a problem—looming retirements funded by sickly portfolios. Consumers have to do their part by making healthy contributions to their nest eggs, but investors should also expect more from those dispensing investment advice. Of course, nothing can guarantee that people will receive quality advice (even from educated and experienced investment advisers), but the current path to becoming a financial adviser is much too easy.

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* Gary Brinson et al., "Determinants of Portfolio Performance II: An Update," *Financial Analysts Journal* (May/June 1991).