Do Investors Get High-Quality Advice?

Research suggests clients often don’t understand incentives shaping behavior of advisors and brokers

**Do you see differences in the quality of advice delivered by fiduciary and non-fiduciary advisors?**

**ANTOINETTE SCHOAR:** The current structure of the market for financial advice exposes investors to a wide array of different service providers. My research suggests that advisors who have fiduciary responsibility toward their clients provided less biased advice than those who are merely registered as brokers. The former were more likely to educate consumers about the erroneous beliefs they might hold about the market—return chasing behavior, for example. They were also less likely to encourage these types of erroneous beliefs. In addition, we found that registered investment advisors were less likely to guide people toward high-fee funds and away from index funds. However, brokers—advisors not acting as a fiduciary—encouraged return chasing and pushed hard against investment in low-cost index funds.

**How do you gauge the quality of advice provided to investors?**

**SCHOAR:** I conducted an audit study, together with co-authors Sendhil Mullainathan and Markus Noeth, looking at the advice that goes into the investment decision. We sought answers to these questions:

1. Do brokers and advisors differ in how they correct well-documented biases (or investment mistakes) that retail customers hold?
2. Do they differ in how they direct clients toward low-fee investment alternatives such as index funds rather than focusing on high-fee options?
3. Do they provide specific customized recommendations based on the needs of the clients?

The answers showed that there are big differences. We sent professionally trained “mystery shoppers” to make more than 250 advisor and broker visits in the greater Boston/Cambridge area of Massachusetts to seek advice on how to invest their retirement savings. We replicated the study with 450 visits in the New York City area. We also varied the shoppers’ levels of bias or misinformation about financial markets to see whether advisors correct these misconceptions.

For example, in half of the visits, mystery shoppers expressed a desire to chase past returns and other well-documented biases that have been shown to have poor returns. Other mystery shoppers went into the advice situation with what you might call a textbook portfolio: well-diversified, low-cost index funds.
What role do incentives play in the quality of advice delivered to investors?

SCHOAR: A large body of literature\(^1\) shows that conflicted advice is bad for consumers because it pits the interest of the broker against that of the customer, rather than aligning them. When brokers are paid on commission for placing customers into specific investment products, their interest is to maximize these commissions, rather than to maximize the performance of the customer’s portfolio. These problems are aggravated if consumers are not aware of or if they do not understand the nature of the conflict of interest that brokers face. My research suggests that customers often do not understand the differences in incentives that advisors or brokers face and the important role that these incentives play in shaping the behavior of the agents they deal with.

Can the value of a fiduciary advisor be quantified?

SCHOAR: I believe that there are several ways in which fiduciary advisors provide value to their clients. First, knowing that your advisor’s incentives are well aligned with your own is an important prerequisite in establishing trust between advisor and client. A number of studies\(^2\) document that financial markets in which customers have trust in the financial professionals they deal with show larger market participation and more willingness among clients to delegate investment choices. In other words, trust is the basis of well-functioning markets. While this might be the least quantifiable dimension, it might be one of the most important.

Second, our research shows that fiduciary advisors saved their clients significant costs by directing them toward lower-fee funds and more passive strategies, while high fees charged by non-fiduciary advisors were not offset by better performance. Therefore, these fees are just a loss to customers.

Finally, we also found that fiduciary advisors provided their clients with better financial education and a broader picture of all their investment choices, rather than directing them predominantly to mutual funds that provide the most fees to the advisor.

Do you think end-investors can discern a non-fiduciary advisor from a fiduciary advisor?

SCHOAR: Unfortunately, only a small subset of US retail investors seems to be informed enough about the market for financial advice to differentiate between advisors and brokers. In an ongoing study that I am conducting with employees from a number of Boston-based companies, we found that less than 30% of employees were able to determine the registration status of a financial professional when presented with different options. Often, these employees even failed to understand that there was a difference among these choices.

Similarly, most participants in the study did not differentiate between financial professionals based on the compensation structures that they use to charge clients.

What metrics do retail investors use to assess the quality of their advisors?

SCHOAR: We found stark differences between people who are financially more sophisticated and those who are not. The former group looks for advisors with good alignment of incentives and judges the advisor based on the quality of the actual advice. The latter group lacks the knowledge to assess the quality of advice and seems to look for softer metrics, such as whether the advisor was friendly and empathetic or treated them respectfully. Unfortunately, they did not respond to the actual quality of the advice.

How can the industry promote better investment decision-making among end-investors?

SCHOAR: Any policy that reduces conflicts of interest between clients and their advisors helps to harness the market’s competitive forces to the benefit of consumers. Therefore, improving the fiduciary standards for financial advisors is a good middle path. It preserves the flexibility of the industry to decide how to organize the provision of advice but still ensures that advisors are acting in the interest of their clients. One important caveat: Investing in financial markets is always risky, so fiduciary standards should be imposed on the soundness of the advice going in. But they should not open up financial advice firms to frivolous lawsuits just because the market went down and a client experienced any losses.

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Diversification does not eliminate the risk of market loss. Risks include loss of principal and fluctuating value. Investment value will fluctuate, and shares, when redeemed, may be worth more or less than the original cost.