clearwater ADVISORS

TREASURY Topics

Brokers vs. Registered Investment Advisors

Why would someone choose to pay an explicit fee to a Registered Investment Advisor (RIA) when they could simply use a broker who charges "no fee"? When reviewing an external investment relationship it is important to understand the firm's legal and fiduciary obligations, conflicts of interest, brokerage affiliations, and decision-making processes, including management checks and balances. RIA relationships are structurally biased to favor the client while brokerage relationships are structurally biased to benefit the broker. Companies terminate broker relationships to improve risk-adjusted returns, minimize conflicts of interest and follow best practice guidelines.

Fiduciary vs Suitability

Under the Investment Advisors Act of 1940, a Registered Investment Advisor must act as a fiduciary. This is a legal requirement to put the client's interests before its own. Conversely, a broker is not bound by a fiduciary obligation but must meet a much lower 'suitability' hurdle. This translates to recommending investments that simply meet the compliance guidelines.

While several bonds available in the market may well be 'suitable' for a portfolio (compliant with guidelines), not all of them are in the best interest of the client. As a fiduciary, the RIA is obligated to place bonds according to what they truly believe is in the best interest of the client, whereas a broker has no such obligation. Brokers are heavily influenced by the level of commission generated by certain securities (i.e. callables, auction rates, and other less-liquid securities), the positions held by the firm's own traders, and proprietary products engineered and marketed by the brokerage.

Compensation

The broker receives compensation from trading securities in multiple ways (often undisclosed or only partially disclosed).

Bonds are purchased from other firms then placed in the client's portfolio at a higher price than the broker paid for the bonds while the broker keeps the difference, or bonds are sold and marked down with the broker again taking the difference. This incentivizes the broker to transact more frequently and in securities with the greatest opportunity for mark-up or mark-down, not necessarily the securities with the greatest benefit to the client.

Brokers sell securities to clients from their own inventory in order to receive a sales credit or commission. This incentivizes the broker to transact with its particular brokerage rather than seek for best execution in the market or to find a security that may be more suitable for the client from another broker-dealer. Investing from this limited pool of available securities rather than utilizing the entire marketplace can significantly reduce opportunities to meet the client's best interests.

When participating in new bond issuance, brokers receive a sales credit known as a concession. Concessions are not considered a mark-up but have the same effect on broker compensation. They incentivize the broker to participate in new issuance sponsored by its brokerage. In addition, new issues with the greatest concession typically have the greatest risk for the end investor, which can directly pit the broker's interests against those of the client.

Because a broker's compensation is often at odds with the interests of its clients, it puts them in the category of an agent of the brokerage firm and not a fiduciary of the client. Clients of brokers should require that their brokers disclose which securities bought into the portfolio are sold from their own firm's inventory and which securities are purchased from other street dealers. In addition, they should require the broker to disclose the mark-up that they passed through to the client on bonds they purchased from other dealers and the sales credit they received on bonds sold from their own inventories. This will allow the client to more clearly understand the opaque cost of their brokerage relationship.

Unlike brokers, Registered Investment Advisors typically receive fixed or asset-based fees that are fully disclosed and agreed upon from the outset of the relationship. Since RIA fees are not increased through trading activity, this incentivizes the RIA to place the best bonds and to seek the best price available in the market, bringing to bear its full expertise and service for the benefit of the client. Any soft dollar arrangement or affiliation that could create a conflict of interest is a required disclosure in Part 2 of Form ADV.

Structure Leads to Risk-Adjusted Performance Difference

The primary function of the broker is sales and relationship management. When an investor hires a broker to manage a fixed income mandate, in most cases the investor has hired a sales group (or individual) for portfolio management, trading, and analysis, supported by administrative staff. While this team contracts with a brokerage house full of expertise and resources, it is the same expertise and resource made available to all of the brokerage's clients including RIAs who use the resources of this broker as well as various others. The RIA's greater access to market viewpoints and strategies coupled with internal analysis leads to independent, non-agenda-driven portfolio management.

Brokers rarely have the *dedicated* team of credit, trading, product or strategy professionals required to manage institutional fixed income assets. Combining these limitations in dedicated resources, independence, and focus with the allure of higher-profit securities, large deviations from the sector weightings and duration structure of the benchmark become commonplace, significantly impacting risk-adjusted returns.

Given the fiduciary requirements, Registered Investment Advisors have an essential separation from a brokerage house and its agenda. RIAs employ independent and dedicated resources for the benefit of the client. The RIA business model is highly focused on excellence in portfolio management. Benchmark analysis, market and credit research, relative value analysis, and targeted allocation strategies with risk and compliance monitoring are the hallmarks of the RIA.

Safe-Keeping of Assets

Custody banks and brokerage custody are used for the safe-keeping of assets in a managed account. In the case of a custody bank (typically used by RIAs), the advisor has authority to direct trades but no authority to initiate wire or asset transfers. This provides protection from the misuse or misappropriation of funds, maintaining a safe arms-length relationship between the assets and the advisor. Brokerage custody has less-strict asset segregation requirements and is thus more susceptible to fraud.

Structurally, a custody bank keeps the assets completely separate from other bank assets which means in the case of insolvency, the FDIC will simply return the assets to their owner in a timely fashion. However for a brokerage, where assets are not as separate, insolvency may result in a pro-rata share of assets returned to investors (i.e. MF Global and Lehman) and it may not be so timely. To fill in some of the potential shortfall, some insurance (SIPC or separate insurance policy) may be offered but this can be *de minimus* in the case of institutional clients where accounts are generally in excess of $500,000.

Incidentally, third-party securities lending strategies carry an even higher risk of large pro-rata losses and longer wait-time for the return of the remaining assets.

Maintaining Checks and Balances

Comprehensive portfolio reporting is requisite to track and evaluate a manager. We recommend a system that provides accurate and timely investment data, monitors compliance to the investment policy, analyzes portfolio risk, and shows portfolio performance based on independent pricing sources.

Such a system will allow the investor to view portfolio positioning, compare risk-adjusted returns to other managers and the benchmark, and monitor when policy guidelines approach or exceed limits.

Due Diligence

In all investment management relationships it is important to require transparency. A periodic on-site visit to each manager is an excellent opportunity to see the operation, understand the dedicated resources, and meet the individuals responsible for managing your assets. Staying abreast of the more subtle changes in management and structure takes a little more time but the peace of mind is worth the energy.

Conclusion

Financial service providers are for-profit organizations. The RIA's fiduciary standard and explicit fee model set the stage for investment management at its best. The suitability standard and obfuscated multivariate revenue model of a brokerage relationship ensure a strong sales effort, but most times a sub-par portfolio management experience.