Four Rules For Smart Investors

Know Your Adviser

One of the basic rules for investment advisers is to know your client. In theory, the reason for that rule is to ensure that the adviser is providing appropriate advice to the client. But it's equally important for the client to know his adviser.

There's a considerable difference in credentials among advisers. The gold standard for advisers is that of Certified Financial Planner (CFP). The process of getting that credential is a multiyear program of education and a challenging test of 170 questions given in two three-hour sessions. The pass rate for this test generally runs between 60% and 65%.

Those who have earned this designation are trained across the broad range of areas most concerned with the finances of the public, such as investments, income taxes, insurance, education planning, retirement planning, and estate planning.

The program for becoming a Charter Financial Analyst (CFA) is even more rigorous, but unlike those who have earned the designation of CFP, the CFA focuses primarily on in-depth analysis of investments rather than the wider scope of topics of interest to the public.

Then there are designations such as Charter Life Underwriter (CLU), which is earned by those seeking in-depth knowledge of the insurance needs of individuals. Although insurance and the concept of risk transference is a common need among individuals, it would be inappropriate to think that insurance is the answer to all of the financial concerns that most folks have.

There are many other designations, including some that are available online for a small fee. The bottom line, however, is that most of the others are little more than meaningless alphabet soup following the "adviser's" name. Caveat emptor.

Help for Fund Buyers

Sorting through the mountain of information about mutual funds is a daunting proposition, yet funds are essential components of most portfolios. So here are several suggestions that may smooth the process.

First, when considering mutual funds, make sure to insist on no-load funds, those with no sales charges. Regardless of the argument your adviser makes, do not buy a load fund. When doing so, you usually begin with a 5% loss. That makes no sense.

Second, whenever possible, buy an exchange-traded fund (ETF) instead of a mutual fund. Why? Because the expense ratios of ETFs are typically half that of mutual funds. When expense ratios are lower, returns are higher. It's as simple as that.

Third, whenever possible, buy mutual funds or ETFs that are on your broker/dealer's no-transaction-fee list. Most of the major houses have these lists, which means there are no commissions for the funds or ETFs that are included.

Fourth, if you do choose to buy mutual funds, insist on those with the lowest expense ratios, typically 1.00% or under.

Finally, for equities you will usually be better served by funds that passively follow major indexes. Fixed-income funds that are actively managed, however, may be superior to those that are passive.

With Rare Exception, Annuities Should Be Avoided

Annuities are rarely the answer to the investor's dream, though they may well be bonanzas for the insurance folks who are selling them. The commissions are high, the details are complex, and words like guarantee are often used to close the sale. Unfortunately, what sounds too good to be true usually is not.

The two main kinds of annuities are fixed and variable. A fixed annuity requires an initial deposit of money in return for a guaranteed periodic payment over a specified period of time. It's intended to provide steady income in the future. If you live longer than the insurance company expects, you can end up ahead on the deal. If you don't, the insurance company wins. But in today's world of unusually low interest rates, it seems likely that only the most risk-averse people will travel this route.

A variable annuity is a different beast. It's a close cousin of a mutual fund portfolio that's sold primarily for its tax-deferral benefits. No taxes will be due until you make withdrawals, so you can move funds around from fund to fund within the universe of choices without tax constraints.

Most variable annuities are quite expensive. Some cost as much as 3% per year. In these days of low returns, that burden could wipe out half or more of whatever gains you have. One exception is the Monument Advisor variable annuity from Jefferson National. Its monthly cost is $20 and there are more than 350 investment options available. If you are out of other tax-deferral options, this one may be worth considering.

Watch Out for Petty Fees from Broker-Dealers

As transaction commissions have come down, some broker-dealers have come up from with nickel-and-dime fees to help take up the slack. Some of the better-known houses charge extra for paper statements. Others charge for the privilege of speaking with their advisers.

There are also fees you don't see, such as the 12b-1 fees, which in essence are sales reimbursements. When individuals buy bunds, typically in small quantities, the markups may be excessive. The list goes on.

The key is to arm yourself with information. Proceed with the understanding that becoming well-informed and asking the right questions will help you avoid the annoying and costly surprises that stand in the way of investment success.