Business Standard

# Professional advice helps: Top 10 myths about financial planning

**It is wrong to believe that those knowledgeable about personal finance should not engage with a Registered Investment Adviser**

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The objective of a financial planning engagement is for a SEBI-Registered Investment Adviser (RIA) to identify and try to fix any personal finance blunders that a client is making. The top three blunders are not saving enough; making too high an allocation to equity; and using high-fee financial products or services.'

Here is a look at the top ten myths about engaging with an RIA.

**My distributor has given me a financial plan:** SEBI regulations clearly state that financial planning services cannot be offered by mutual fund distributors (MFDs). They can only be offered by RIAs. This is because MFDs have a conflict of interest. For example, equity mutual funds typically pay double the annual commission compared to debt mutual funds. Hence, it is tempting for an MFD to recommend a dangerously high allocation to equity mutual funds. Also, regulations do not require MFDs to have even the bare minimum education and competence required to do financial planning calculations.

**Any RIA can calculate how much I have to save:** Competent RIAs typically use conservative assumptions about investment returns, life expectancy, and career trajectory. As an illustration, a competent RIA might calculate that a client should save 60 per cent of their post-tax salary. Most clients would be shocked by that.

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On the other hand, incompetent RIAs typically use optimistic assumptions and might calculate that the same client should save 33 per cent of their post-tax salary. The client, like most clients, is likely to find that the incompetent RIA's calculation better matches the client's intuition about how much they should be saving. If the client follows the incompetent RIA's recommendation, she is likely to run out of money well before the age of 70.

**Financial planning means getting a document:** It requires a total of less than one hour of effort to create a low-quality financial plan document that looks like it has been customised for a particular client. A high-quality hourly-fee (else then, Fixed-Fee) RIA will instead speak to a new client for around five hours to understand the nuances of that client's situation and also explain to the client why they should change what they are doing.'

**All RIAs put in the same amount of effort:** If an RIA speaks to a new client for 1.5 hours that means that the RIA is typically putting in another 1.5 hours of back-end effort directly for that client. Such an engagement minimises the total fee and hence is ideal for lower-middle-class clients. On the other hand, if an RIA speaks to a new client for five hours that means that the RIA is typically putting in another five hours of back-end effort. Such an engagement aims to uncover hidden issues and hence is ideal for middle-class and upper-middle-class clients. The number of hours of effort is roughly one-third in subsequent years in case the client renews the engagement.

**Investment advice means selecting Active Mutual Funds:** It makes sense to invest in passive index funds, for example the Nifty 50 Index Fund (Direct Plan), rather than active mutual funds. Hence, ideally RIAs should recommend passive index funds.

**One per annum of Assets Under Management is a fair fee:** A client paying fees of one per cent per annum of Assets Under Management to an RIA is mathematically equal to the client paying a total of 26 per cent of the client's Assets Under Management to the RIA over 30 years. Clients should instead pay an hourly fee, else then a fixed fee, based on the number of hours of effort. Clients should then execute their investments themselves since it is very easy to do so and is not worth paying for.

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**HNIs should not spend more on RIA fees:** For simplicity, let's focus on clients who are 60 years old. For example, client X has a net worth of Rs 1 crore and ideally should spend Rs 10,000 annually on RIA fees (in general, averaged over the first five years of the engagement). And client Y has a net worth of Rs 40 crore. It would be penny-wise and pound-foolish for client Y to spend only Rs 10,000 annually on RIA fees. Doing so would mean that client Y cannot engage with the most qualified RIAs or should limit the discussion to only the one most important topic. It may instead make sense for client Y to spend around Rs 1 lakh annually on RIA fees.

**I want the fees to be based on returns:** It is irrational for a financial planner to charge fees based on returns for two reasons. First, it is practically impossible to measure the quality of advice based on the returns. For example, if an RIA recommends fixed deposits with risky co-operative banks or NBFCs, then in the short-term it will most likely lead to higher returns but in the long-term the client might lose their entire investment. Second, an RIA is only allowed to make recommendations and the client has to take every single decision about whether or not to implement each recommendation. Hence, SEBI does not allow RIAs to charge fees based on returns.

**I can do the calculations myself:** Since many RIAs are unable to correctly calculate the amount that has to be saved for retirement, it is unlikely that someone who is not an RIA will be able to do the calculation correctly. Hence, even clients who are very knowledgeable about personal finance should search for and engage with an RIA.

**Novices should seek financial advice:** It is dangerous for those who know very little about personal finance to seek advice, since they are very likely to do so from an MFD or an insurance salesperson. Instead, such a person should learn the basics of personal finance before they seek advice.

(The writer is an hourly-fee financial planner and SEBI RIA at Fiduciaries.in. He was a private-equity investor for 12 years.)