Sudden Wealth: Advising Clients for Financial Windfall

By Steven S. Kirkpatrick

https://www.americanbar.org/newsletter/publications/gp_solo_magazine_home/gp_solo_magazine_index/sudden_wealth.html

The topic of advising clients for financial windfall brings to mind a favorite joke that occasionally makes its way through wealth management circles. A hapless character, who we will call Joe, is being interviewed by a reporter three years after winning a $5 million lottery. “Joe,” begins the reporter, “just three years ago, you won 5 million bucks, and now it’s almost gone. Where did the money go? What happened?” Joe reflects on the question for a few moments, and slowly answers: “Well, about half the money was spent on gambling, women, booze, and partying. The other half . . . well, I don’t know—I guess I just wasted it.”

One hopes that none of us will have clients as irresponsible as Joe, but even a reasonably prudent and intelligent client can suffer financially in the absence of a well-thought-out financial plan. Receipt of a financial windfall is a dramatic event, and your client likely may face considerable personal and emotional challenges in trying to adjust his or her lifestyle and to cope with newly found wealth. Thus, the best approach to advising clients for financial windfall entails almost as much introspection and soul searching as it does financial planning. In this regard, a bit of “coaching” might be very helpful.

For example, you should encourage your clients not to make any sudden or dramatic changes in lifestyle. You also may want to remind them that, even if the windfall seems like a lot of money, it could well be lost if not properly managed. As an example, studies have shown that up to one-third of lottery winners ultimately end up seeking some sort of bankruptcy relief. Advise your client to proceed cautiously, to hire a financial advisor immediately, and not to make any significant commitments until a complete financial plan is in place. You also should ask your client to consider whether or not decisions regarding the money should be made unilaterally or in collaboration with others, particularly a spouse and perhaps children.

Both the degree to which the financial windfall is anticipated and the extent to which the money can change your client’s lifestyle can represent significant psychological challenges. If your clients have the “urge to splurge” immediately, try asking them how much of their money they would like to have left in five or ten years or at retirement age. Remind them that new homes and expensive toys cost a lot of money to maintain and insure, and that they will need good advice about what sort of lifestyle they can afford to maintain over time. Also, wealth is a personal, private matter. Encourage your clients to keep it that way and to exercise considerable restraint in sharing the news of the windfall. It can be difficult to resist the pressure of friends and family and other cadgers hoping for a share of your clients’ bounty.

There is a diverse array of challenging issues that the recipient of a financial windfall should address promptly, and this should be done in a comprehensive fashion. Important and fundamental issues need to be examined carefully, such as:

- the type of lifestyle your clients hope to achieve given their windfall;
- the need for a comprehensive plan to achieve and maintain the desired lifestyle;
- consideration as to how much money should be spent, donated, and gifted, rather than invested;
- plans for subsequent significant purchases (e.g., second home, college education, etc.);
- determination of income needs based on the desired lifestyle; and
- creation of an investment plan that generates the necessary income.

Encourage your clients to avoid any sort of “alternative” investment, such as private partnerships and “business deals.” There are times when my clients have sought feedback from me on certain investment schemes where their perception of risk was, perhaps, clouded by the excitement of the concept (restaurants are a perennial favorite, followed closely by art galleries). My advice is almost always the same: “It’s an interesting idea, but you may as well just take the money to be invested and set it on fire. It’s faster and easier and ultimately generates a lot less angst than watching your investment gradually collapse.” Yes, some of these ventures do turn out well, but the risk almost invariably exceeds the potential reward. You don’t want your client to learn this the hard way.

As noted by Steven Hayworth, the founder and CEO of Gibraltar Private Bank, “the recipient of a sudden liquidity event has a new and very important job and, in my experience, it’s one in which they likely have no or very limited experience. The thoughtful and competent stewardship of an individual or a family’s financial resources is their new job and it must be taken very seriously.” Learning this new job will take time and requires both discipline and restraint, but ultimately it will serve your client well. Adds Hayworth, “the failure of an individual and a family to develop competency regarding the careful and thoughtful management of their financial resources is the principal reason for the depletion of significant wealth.”

Selecting a Financial Advisor

Clearly, the most important question facing the recipient of a cash windfall is the selection of a financial advisor. If your clients are not experienced and sophisticated in financial and investment matters, you would serve them well by helping them evaluate their options regarding the selection of a financial advisor. In seeking assistance to deal with a financial windfall, one can turn in many different directions for advice. There are, for example, numerous designations within the financial advisory community that are offered by various industry organizations, any of which represents that the holder thereof has a certain degree of credibility and expertise. Examples of some professional designations include certified financial planner, certified public accountant, certified retirement financial advisor, chartered financial analyst, chartered financial consultant, and certified investment management analyst.

Certain designations, and certain financial advisors, will no doubt be better suited to your client than others. For example, the designation “certified financial planner” requires a fairly broad base of knowledge in many disciplines, which might be useful for looking at your client’s overall financial situation. On the other hand, the designation “chartered financial analyst” is earned only after completing a rigorous program that focuses on financial analysis and investment management. This designation may be considered a very desirable qualification for a portfolio manager.

Advisory relationships are inherently personal; it is critical that clients feel comfortable with their advisor. It must be someone that they trust—and whose advice they are willing to accept. It is also very important that clients understand the "value added" role played by advisors. Thus, there should be a two-way flow of information between clients and advisors in order to make a successful relationship, where the advisors know the client well and the clients understand what the advisors do on their behalf and why. As explained by Hayworth, "an advisor's keen and sincere interest in investing the time and energy to develop the client's financial competency is critical for both parties. Doing so will create a relationship based on trust and will ensure that the expectations of returns, assessment of risk, liquidity, and other important factors are appropriate and in line with established goals and objectives."

Note that it is also perfectly reasonable (and often wise) for your clients to rely on several different advisors to manage their financial affairs. This might include, for example, a certified financial planner to prepare a comprehensive plan to address savings, investments, and retirement planning; a chartered financial analyst to make investments and manage securities; and a certified public accountant to offer advice on tax strategy and to prepare tax returns. In fact, you should caution your client to avoid any advisor who is reluctant to work with other professional advisors as part of a team. The best results frequently require teamwork, and if there is a problem with an advisor, another member of your client's team would be most likely to identify it.

In addition to professional designations from industry associations and organizations, there are also professional designations that entail registration with a government or industry regulatory agency, notably "broker" and "investment advisor." Although the distinction between the two is often blurred, these differences are actually quite significant and should be understood by your client.

Investment Advisors

Investment advisors are people or firms that get paid to give advice about investing in securities; they generally must register with either the Securities and Exchange Commission (SEC) or the state securities agency where they have their principal place of business. Investment advisors who manage $25 million or more in client assets are required to register with the SEC pursuant to the Investment Advisors Act of 1940.

Investment advisors owe a fiduciary duty to their clients; in this regard, they must avoid conflicts of interest, make full disclosures of fees, and put their clients' interests ahead of their own. As a fiduciary, the advisor generally has a continuing duty to monitor and advise the customer regarding performance and material events affecting the underlying investments. For discretionary accounts, as circumstances may dictate, the advisor may be obliged to initiate appropriate, affirmative action to advance the customer's interests.

Some investment advisors employ investment advisor representatives, the people who actually work with clients. In most cases these people must be licensed or registered with state securities regulators. Information about registered investment advisors can be found in their registration papers filed with the SEC. The Form ADV, as it is called, has two parts. Part 1 has information about the advisor's business and whether he or she has had problems with regulators or clients. Part 2 outlines the advisor's services, fees, and investment strategies. Before your clients hire an investment advisor, they (or you, as their lawyer) should carefully read both parts of the ADV.

One can view an advisor's most recent Form ADV online by visiting the Investment Advisor Public Disclosure website at www.adviserinfo.sec.gov.

If investment advisors manage less than $25 million, research must be conducted with the state securities agency in the state where they have their principal place of business. Contact information about state securities regulators can be found at the North American Securities Administrators Association website: www.nasaa.org.

Brokers

Brokers, on the other hand, are basically salespeople whose primary responsibility is assisting clients in the execution of stock and other securities trades. They do not have investment discretion; actual investment decisions are the responsibility of the client. Brokers are regulated by the Financial Industry Regulatory Authority (FINRA), created in July 2007 through the merger of the National Association of Securities Dealers (NASD) and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange.

FINRA imposes a "suitability standard" rather than the stricter fiduciary standard. This simply means an investment sold by a broker must be suitable for the client. Once the sale takes place, there is no ongoing monitoring of the investment (such as advice concerning when to sell). Traditional brokers are not subject to the Investment Advisors Act, and therefore they do not owe their clients a fiduciary duty as required under the act. Rather, they are subject to the Securities Exchange Act of 1934 and the rules of other self-regulatory agencies, notably FINRA.

FINRA has an online database called BrokerCheck that contains information about most brokers, their representatives, and the firms they work for. For instance, you can find out if brokers are properly licensed in a particular state and if they have had problems with regulators or received serious complaints from investors. You'll also find information about the brokers' educational backgrounds and where they've worked before their current jobs. BrokerCheck can be reached at the following link: www.finra.org/Investors/ToolsCalculators/BrokerCheck/index.htm , or via telephone at 800/289-9999.

In sum, brokers must know their clients and recommend suitable investments, but unlike investment advisors, brokers are not legally required to put their clients' interests ahead of their own, make the same level of disclosures about fees, or recommend the very best investments—just suitable ones. Also, because some investment advisors and their representatives are also brokers, you may want to conduct research on both BrokerCheck and the Investment Advisor Public Disclosure website.

If your client plans to do business with a brokerage firm, you should find out whether the brokerage firm and its clearing firm are members of the Securities Investor Protection Corporation (SIPC). To search for a particular firm, go to www.sipc.org/who/database.cfm. SIPC provides limited customer protection if a brokerage firm becomes insolvent. If an investor delivers cash or securities to a non-SIPC member, they may not be eligible for SIPC coverage if the firm goes out of business.

Choosing the Right Advisor

In considering the choice of a financial advisor, it is very important to understand how they get paid. Advisors that have a relationship with an insurance or brokerage company may have a conflict of interest: They may collect revenue from investment products where the revenue is not disclosed to the client (such as finders' fees paid by some mutual funds or commissions paid on

variable annuity products). The only source of revenue that a financial advisor should have is the client—revenue from any other source creates conflict of interest. Also, brokers have an incentive to sell product rather than grow wealth. Although not a conflict per se, such a relationship is prone to creating a misalignment of objectives between broker and client. Overall, brokers are held to different and somewhat lower standards than registered investment advisors. Thus, unless your clients have a fairly high degree of financial sophistication and the desire to manage their own portfolios, you should advise them to work with an investment advisor rather than a broker.

The most common compensation structure used by investment advisors is based on a percentage of assets under management. Although these fees do vary somewhat and are usually on a sliding scale, for equity portfolios (i.e., investment accounts holding common and preferred stocks) they usually begin at about 1 percent to 1.25 percent of the first few million dollars under management and then decline to less than 1 percent for additional increments of funds. Fees on fixed income portfolios are usually in the range of one-half of equity fee rates.

When evaluating prospective financial advisors, checking references and seeking referrals from trusted sources is a very good idea. Also, a formal evaluation process that includes asking specific, detailed questions is recommended. A useful set of questions can be found at the SEC website (www.sec.gov/investor/brokers.htm) and also from the AARP at http://assets.aarp.org/www.aarp.org_/articles/bulletin/money/financialquestionnaire.pdf.

In addition to the foregoing, there are other questions that your client may want to ask. For example:

- How big is the firm, and how many clients do they have? A larger firm can offer one-stop shopping for a full range of services but may lack the personal touch of a smaller firm. On the other hand, smaller firms will likely use third-party sources for certain functions.
- What kind of clients does the firm serve? Your client should select a firm that serves clients with a similar degree of wealth and broadly comparable investment goals.
- Who will the client be working with, who is the contact point, and who actually makes decisions? Your client should have direct access to the person making investment decisions.
- What is the firm's investment performance (net of fees)? In measuring performance, the most reliable data meets Global Investment Performance Standards as promulgated by the Chartered Financial Analyst (CFA) Institute. Do not rely on claims of investment performance that do not meet these standards.
- Does the firm specialize in a particular investment strategy or style? If so, this may constrain investment options or leave your client with a poor selection of investment choices given their needs.
- How often will your client meet with the advisor, and how should performance be evaluated? A great investment advisor will insist on regular structured meetings and a disciplined process for evaluation of results.

One should never deliver funds to an advisor without first signing a contract. The contract should be very clear about who has responsibility for making investment decisions (as noted above, usually not your client), and it should also include (often as an exhibit) a statement of investment objectives that creates a mutually agreeable set of guidelines about the type of investments to be

made on your client's behalf. Investments should be limited only to marketable securities and other highly liquid investments.

Substantially all such contracts include a provision that requires arbitration in the event of a dispute. This can work against your clients, of course, as it limits their remedies if a serious problem arises. In any case, it is unlikely that any reputable firm would be willing to execute a contract without this provision. Thus, if the advisor loses your client's money, it is likely that the only recourse will be through arbitration. But if you and your client do your homework and select a reputable advisor suitable for your client, and you continue to work diligently as a team, your client's long-term outlook will indeed be positive.

Steven S. Kirkpatrick is president of Closeburn Asset Management, LLC, in Huntington, New York. He is also co-founder and managing director of Dunkirk Governance Specialists LLC. He may be reached at steven@closeburnassetmgt.com.

Copyright 2008