# Financial science drives industry product development, but not necessarily toward the best interests of individuals

**Category : Are Your Best Interests the Same as the Financial Services Industry?**

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*Summary: Personal financial decisions seem to have become very complicated. To add to the confusion, the financial services industry develops an unending array of supposedly innovative new products. However, a large part of the complexity that individuals face results from the proliferation of repetitive financial products in a myriad of flavors with different features and different financial trade-offs. What is "best" and "right" for individuals easily gets lost in the ensuing confusion.*

Well-educated specialists in the financial services industry have been the primary non-academic consumers of academic research in finance. Creative "sell-side" professionals select from this research to develop sometimes innovative, but most often simply repetitive financial and investment products for sale to "buy-side" institutions and to individuals. The institutional "buy-side" of the financial industry tends to be more knowledgeable and discerning consumers of these innovations, when compared to individuals. However, in turn, the institutional "buy-side" of the industry also develops innovative and/or repetitive financial products and services, and then offers them to individuals either directly or through the financial advisor network.Along this chain, objective academic knowledge of what is "best" and "right" for individuals tends to morph into product development and sales strategies that appeal to people's personal insecurity, greed, and ignorance. Sales messages pander to people's frustrations and need for simplification of what the industry itself has turned into a highly complex subject. In addition, along this chain of financial product development, many offerings to individuals tend to pick up extremely undesirable characteristics, in particular, high risk and high costs. Furthermore, products and indexes may be developed to exploit erroneous investor beliefs, such as trend extrapolation related to superior historical performance.*The Skilled Investor* believes that much of the financial product complexity that individuals face is unnecessary and can be dispensed with through use of scientifically based product screening criteria. Much of the complexity that individuals face results from the proliferation of repetitive financial products in a myriad of flavors with different features and different financial trade-offs. In an often highly arbitrary sales process, industry agents attempt to sell this vast array of financial products to consumers. Without doing highly personalized and sophisticated needs analysis, a thin veneer of ersatz financial planning is offered. This faux financial planning is followed rapidly by a "consultative" sales process that usually pushes excessively risky and costly products. In their pursuit of sales compensation, it does not really matter to many sales agents that your particular financial needs are square-shaped or octagonal-shaped. You are the sales prospect at hand. If you are susceptible to the sales pitch du jour, your real financial needs may get hammered into the round hole that that a particular sales person has a personal financial incentive to fill. What is "best," "right," or even appropriate to an individual's needs and circumstances may take a back seat to making the sale. After intelligent individuals wade through the intricate tradeoffs between financial alternatives, decision fatigue is highly likely. It is no wonder that many people just want someone to trust who will give them a simple answer to this largely industry induced complexity problem.
Because the preceding paragraphs might seem to have a cynical tone, it may be necessary to

remind you that there are many, many thousands of good and ethical financial advisors in the profession. Furthermore, scientific studies of the practices of individual investors who lack good advisors have demonstrated that many individual investors are sorely in need of competent help. (See: What is the cost to individual investors of sub-optimal portfolio diversification?) With that in mind, however, you should be very careful about your advisor selection process. Unfortunately, some financial advisors really do fit the description of the previous paragraphs. (See: Preparing to interview a financial planner or investment advisor)You might like to read a recent and very enlightening study that touches on some of the problems discussed above. After reading this study, you might change your mutual fund buying habits and save yourself substantial sums of money for the rest of your life. In this Harvard Business School finance working paper, "Assessing the costs and benefits of brokers in the mutual fund industry," Professors Bergstresser, Chalmers, and Tufano analyze the value-added of the broker sales channel for mutual funds.1 In their conclusion, they state that "We begin with a positive hypothesis: the prominence of funds sold through brokers implies that brokers provide consumers with valued services. Our study has identified few, if any, of these benefits." This is a rather stark conclusion, when you consider that the great majority of mutual funds are sold through brokers and other financial advisors. In buying mutual funds through brokers and advisors rather than purchasing them directly from fund companies, individuals incur very substantial front-end or back-end sales load charges, and they pay substantially higher ongoing fund management and marketing expenses. Individual investors unnecessarily waste billions of dollars every year by purchasing mutual funds through brokers and advisors rather than buying directly.

1 Bergstresser, Daniel B., Chalmers, John M.R. and Tufano, Peter, "Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry" (January 16, 2006). AFA 2006 Boston Meetings

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