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Seven Questions to Ask When Picking a Financial Adviser
No 1. Are there any skeletons in the closet?

By SHELLY BANJO

As investors look for guidance in these troubled markets, one question looms above all others:

Whom can you trust?

During boom times, it was easy to hire a financial adviser and put your money on autopilot. Now the market is in chaos and thousands of investors have been devastated by fraud, with Madoffed threatening to become an all-too-common verb.

Small wonder that many investors are getting reluctant to put their faith in experts. More than three-quarters of individuals with at least $1 million to invest intend to move money away from their financial advisers, and more than half intend to leave their advisers altogether, according to Prince & Associates Inc., a market-research firm.

The trouble is, many investors don't have the time or expertise to make all of their own investment decisions. So, having a professional on your side is crucial. But how can you guarantee that your expert is reliable?

The short answer is that you can't. There are no guarantees. But you can be a lot more sure than many investors are today.

The first step is to realize that you're ultimately responsible for your family's money -- you're the chief executive of your own investment company. Your financial adviser, mutual-fund manager, wealth manager and anyone else who handles your investments should report directly to you. Even if you don't understand the ins and outs of investing as well as they do, you're responsible for ensuring that they handle your money properly.

"Being a CEO doesn't mean you make every trade, but you do have to be able to manage a team of people with quality expertise, realizing that not everyone in the profession knows what they are doing," says Michael Sonnenfeldt, co-founder of Tiger 21, a peer group for wealthy investors based in New York.

Once you recognize that you're in charge, you can approach your advisers like a boss -- not just a client. That means putting them through a tough vetting process to make sure they're competent, trustworthy and looking after your best interests. Here are some big questions to keep in mind as you review your candidates:

1. What's in the adviser's background?

"Think like an employer," looking at a potential adviser's criminal and regulatory record, as well as references from past employers, says Wayne Cooper, founder of Wealth Management Exchange, a social-networking site for high-net-worth investors.

You can find regulatory records for stockbrokers, investment advisers, insurance agents and their firms online, starting at Finra.org, the Financial Industry Regulatory Agency's Web site. Finra's BrokerCheck will tell you which states and regulatory organizations that brokers and their firms are registered with, along with the licenses they hold, the exams they've passed, and their employment history.

Following news of million-dollar frauds executed by Allen Stanford and Bernie Madoff, investors may be re-examining their own money managers. Dow Jones Newswires' Shelly Banjo discusses ways to check up on your financial advisor's credibility.

The site also lists any formal investigations and disciplinary actions initiated by regulators, along with customer disputes, certain criminal charges and financial disclosures, including bankruptcies.

For investment advisers with firms regulated by the Securities and Exchange Commission -- usually those managing more than $25 million -- go to http://adviserinfo.sec.gov and click on "Investment Adviser Search" to see part of the "Form ADV," a document the SEC requires all investment advisers to fill out when registering.

The online portion of the form will give you information about an adviser's clients, fees, business and disciplinary history within the past 10 years. The second part of the form -- which isn't online -- contains information on an adviser's services, fees, code of ethics and investment strategies. To see a copy, ask the adviser's firm, your state regulator or the SEC.

Investors can find more information about advisers, including education and work history, at the Web sites of organizations such as the Certified Financial Planner Board of Standards Inc. (www.cfp.net) and the Financial Planning Association (www.fpanet.org).

But all of that leaves an important question open: What exactly constitutes a red flag in an adviser's history?

"A discriminating person wouldn't just look at the fact the adviser had a complaint," says George Brunelle, a New York securities lawyer. He suggests looking for complaints related to customer disputes, fraud or excessive buying and selling of securities, called churning. Investors should zero in on disputes that led to a substantial arbitration award.

On the other hand, some technical infractions -- such as failure to comply with continuing-education requirements on time are more common and may be permissible. Either way, there are lots of advisers out there, so "it is best to comparison-shop," Mr. Brunelle says.

2. What do the adviser's clients say?

Don't wholly depend on the reputation of a big firm or recommendations from friends, family or members of your country club. After all, Bernard Madoff would likely have gotten glowing recommendations from many noted people, says David Kudla, chief executive of Mainstay Capital Management in Grand Blanc, Mich.

People who refer you to an adviser may also have different goals than you. For instance, your golf buddy may want to retire before age 40 and doesn't have any kids to think about. But you may be planning to retire at age 75 with money left over for your three kids. Thus, your financial plans and needs will vary drastically.

So, it can be helpful to ask for references from past and current clients in life situations similar to yours. When talking to the clients, get specific about their experiences. How often did the adviser communicate with them? Has the adviser ever admitted to making a mistake? How often do they evaluate their goals with the adviser? Has anything about their relationship surprised or disappointed them? Has the adviser performed well in bull and bear markets? Is the adviser ethical?

Then ask them for additional references from people the adviser hasn't solicited, says Greg Rogers, founder and president of RayLign Advisory LLC in Greenwich, Conn. "Try to find six degrees of separation from the adviser," he says. "You'll get better information if you get indirect references."

3. How does the adviser get paid?

Knowing how advisers get paid will help you tell if they're working in your best interest. "It's no different than going into a clothing store -- when a salesperson says you look great, you know they have a bias to sell you clothes," says Mr. Sonnenfeldt, the Tiger 21 co-founder.

Advisers use a bunch of compensation structures. They may get a commission on the securities they sell; charge fees, either flat or a percentage of the assets they manage for you; work at an hourly rate; or a combination of all of them. Ask advisers to detail exactly how they work and the total compensation picture from managing your portfolio. Be wary of anyone who shies away from answering these questions in a transparent way, Mr. Sonnenfeldt says.

Also ask about conflicts of interest. For example, if advisers work on commission, ask for their firm's commission schedule and find out if there are a limited number of products or services they can recommend and why. If they can't justify the limited choice, that's a red flag. Meanwhile, if advisers take a percentage of assets as a fee, remember that they may be inclined to advise you to avoid moves that may reduce those assets, including charitable giving or buying a new house. Also be wary of an adviser who charges more than 1% or 2% of assets.

4. Where are the adviser's checks and balances?

The most glaring red flag in the Madoff scandal was the lack of checks and balances. Mr. Madoff's clients wrote checks and wired money to, and received statements from, Bernard L. Madoff Securities. The operation's auditing firm, Friehling & Horowitz, had only one licensed accountant and was operating out of a storefront in New City, N.Y. Madoff investors relied on this firm to verify the authenticity of trades, the SEC said in a complaint.

When purchasing investments, make sure you are writing checks to a third-party custodian, like Fidelity Investments Co. or Charles Schwab & Co., not to your financial adviser directly. This way, "an adviser can make purchase decisions based upon my instruction, but they can't run away with my money," says Wealth Management Exchange's Mr. Cooper.

Call the independent institution to verify it's serving your adviser, and never send checks anywhere but that firm's business address. What's more, don't allow your transaction confirmations and account statements to be mailed to your financial adviser instead of you. You should receive account statements from a third-party custodian.

Likewise, find out what auditors your adviser's firm uses. Auditors are crucial, since they verify the existence of the assets your adviser manages. Each state has its own database to check if an auditor is licensed. (While you're at it, check if your adviser has switched accounting firms or custodians recently, a move that could indicate trouble with the previous firm.)

It's also important to ask advisers about another kind of oversight: how the advisers conduct due diligence on any money managers they recommend investing with. Do they check out the managers' balance sheets, and how their actions line up with their investment strategies? Do the advisers have a personal relationship with the managers or get kickbacks from referring you?

Note, though, that it isn't uncommon for advisers to get a referral fee, "as long as they disclose who is getting the money and demonstrate why they are recommending" the particular money manager, says Ken Springer, president of Corporate Resolutions Inc., a corporate-consulting and investigative firm.

5. What's the adviser's track record?

Advisers sometimes say they can't easily describe their track record, since they tailor each portfolio to an individual client's needs. But that excuse doesn't hold up. "There are many ways to evaluate an adviser's track record," Mr. Sonnenfeldt says.

For example, you might ask: How many clients beat their benchmarks or are in line with their goals? How have clients similar to me fared during recessions? Can you combine all of your clients into a single portfolio and tell me how the overall portfolio did? Remember to ask about both short-term (one year) and long-term (10 years or more) records, and ask if your adviser is using absolute returns or returns relative to the performance of the market.

Next, use the advisers' record to understand how they make decisions. "You can ask about performance, but what you're really after is how the adviser processes decisions," says Mr. Rogers of RayLign Advisory.

He suggests asking advisers to dissect a specific situation that has occurred to them. For instance, you could say, " 'Take your worst investment and evaluate how you made the investment, monitored it and the decisions you made along the way to stick with it or get out,' " he says.

"If you feel they are dodging the question or putting a positive spin on everything, it's a red flag," Mr. Rogers says. "It could mean they're not going to deal with or handle the tough decisions."

Finally, be watchful for claims of all-too-consistent returns. No adviser can deliver 10% to 20% returns every year. More reasonable -- and responsible -- is an adviser who says they may get you 10% one year, 2% the next and so on, Mr. Rogers says.

6. Can the adviser put it in writing?

Ask for a formal written outline of the services the adviser will be providing and what fees you will be paying. By setting concrete expectations, you can determine if an adviser is going to, say, "help you set goals and do budgeting or just make investment decisions," says Ellen Turf, chief executive of the National Association of Personal Financial Advisors.

For instance, you can ask advisers to spell out what they think you are trying to achieve and what they think you should do to get there, including investment strategies, specific benchmarks and suggested financial products. If advisers can't explain their plan in simple terms, another red flag should go up. Secret strategies like those touted by Mr. Madoff are no longer acceptable, Mr. Sonnenfeldt says.

Also ask advisers to spell out who else stands to gain from your relationship -- such as affiliated broker-dealers and insurance agencies -- as well as exactly how much the adviser, the adviser's firm and all those other parties will earn from your business.

Finally, find out whether the advisers are going to take on fiduciary responsibility, in which they are legally bound to act in your best interest. If advisers don't take this oath, they're only required to sell you products that are deemed suitable for you -- and those may not always be the best fit for your financial situation or objectives.

7. What do other pros think?

Sure, you pay your adviser to do the heavy lifting, but it's imperative that you double-check any big moves -- especially in this turbulent economy.

That means knowing the basics behind your investments, insurance, estate planning and taxes, and then turning to other experts for confirmation. For instance, if your financial adviser recommends investing in commodities, read up on recent news affecting the commodities markets and then search out an expert and ask questions.

"Just like you would ask a specialist for a second opinion on your doctor's diagnosis," ask your accountant, lawyer and other financial professionals for their opinions on individual strategies, Ms. Turf says.

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