Saying Goodbye to the “Retail Model” of Investment

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The following is adapted from Navigate the Investment Jungle.

As an investor, you want to trust that your financial advisor has your best interests at heart. You also want to trust that your advisor has the knowledge to serve those interests.

Over the years, it’s become increasingly obvious to me that many financial advisors are missing not just one, but *both* of those pieces.

The problem is what I call the “retail model” of investment, in which financial advisors sell investments like retail products and seek high returns without properly managing risk, often in the pursuit of higher commissions. For better investing, it’s time to say goodbye to this outdated model.

My Experience with the Retail Model

Early in my career, I followed the retail model. I learned from mentors who showed me how to construct a portfolio based on the principles of that model. When I was unsure which investments to prefer, they guided me to a list of mutual funds recommended by the firm where I was working.

Naturally, I picked from the menu I was given. Naïvely, I imagined that the funds on that menu were chosen because they offered the best performance. That wasn't necessarily the case. It turned out that many of the recommended funds were the ones offering brokers the highest commission.

I can still remember the first time my belief in the rightness of this approach was dented. A very conservative client of mine sat down with me for a meeting and began to ask pointed questions about his investments. Although this man was heavily invested in treasury bills and government bonds, he also had a portion of his portfolio in mutual funds. My firm was responsible for managing that part of his investments. At the time, the mutual funds weren't performing well.

As he began to ask me questions, I started to recognize the gaps in my knowledge. For example, he found an abbreviation in his quarterly report that read "FFO." What did FFO mean? To my chagrin, I had to admit that I didn't know. It wasn't until later that I learned it referred to funds from operations.

At the time, that conversation wasn't enough to shake my faith significantly. Nonetheless, it must have made quite an impact because I still remember it decades later. My inability to answer that client's questions or explain the performance of his investments was a clue to the limitations of the retail model.

The Foundation of the Retail Model: A Buy-and-Hold Strategy

The retail investment model is centered on a buy-and-hold strategy. It's an incredibly common approach, practiced by some of the largest money managers in the world. Indeed, the two largest investment managers in terms of amount of money managed—Barclays Global Investors and State Street Corporation—utilize this strategy.

Wikipedia defines a buy-and-hold strategy as: "An investment strategy where the investor buys stocks and holds them for a long time, with the goal that stocks will gradually increase in value over a long period of time."

Buy-and-hold is based on the belief that investors will never see good returns if they bail out following a decline, so the smartest approach is to hold on to their assets and wait for the market to bounce back. It's a passive strategy, not a proactive way to manage money.

It's also a strategy that works for financial professionals regardless of what happens. If the investor holds on to stocks during a downturn until those stocks rebound in value, the advisor reaps an increased commission. If the investor gets antsy and sells, the advisor earns a commission on the transaction.

A buy-and-hold strategy can work, especially in good times, but it's a risky approach that can also yield big losses for the investor.

An Alternative Approach: The Institutional Model

When the markets hit a rough patch, the retail approach has little practical advice to offer. You can hold on in the hope that things will get better, or you can sell in the hope of cutting your losses. However, investing doesn't have to be that way. Instead of investing like a retail consumer, you can invest like an institution.

Instead of striving for quick results, institutions are focused on building a significant endowment over decades. As such, they allocate assets differently, putting much less money in stocks (just 20 to 30 percent of the total portfolio) and employing alternative investments, such as real estate and United States Treasury bonds. This approach reduces risk and limits the severity of losses in bad times, while delivering solid returns in good times.

So if you want steady, safe wealth accumulation, say goodbye to the retail investment model, and say hello to the institutional model.

For more advice on the institutional model of investing, you can find Navigate the Investment Jungle on Amazon.

Douglas Stone is a wealth advisor with SeaCrest Wealth Management, who brings twenty-three years of experience to his work with affluent households. Douglas began questioning his industry's approach seven years into his career, and in 2009, he left the major wirehouse where he worked to become an independent advisor. For six years, he discussed his self-taught, holistic approach to wealth management on Real Money with Doug Stone, a radio program on KMED 1440 AM in Medford, Oregon. Today, Doug shares his knowledge and expertise through workshops, seminars, and speaking engagements.