Reverse Churning and the Art of Doing Nothing

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Do you really know and understand what your financial adviser is doing with your investment accounts every year? Are you aware of the subtle investment strategies and techniques used to make investment decisions? These are questions most people would likely answer with “no”. Oftentimes, you hire an investment adviser to help provide discipline to your portfolio and make good, strategic decisions based on the market and the economy. In my experience, it seems quite often most people don’t spend the time necessary to go through their statements on a monthly basis to investigate what exactly their adviser is doing and that’s scary. What’s equally frightening is not knowing what’s happening with your finances and leaving the investment strategy up to chance. Now, the SEC and FINRA are taking a closer look at advisers and their actions, or lack of action, in a practice known as reverse churning.

What is reverse churning?

Reverse churning is essentially your adviser doing little to nothing with your investment account – making very few to zero trades/changes per year – yet still collecting a fee from you. The SEC and FINRA are starting to take notice and are rolling out regulations to put pressure on advisers to make trades in clients’ investment accounts. This swirling confluence of new rules is creating an environment where everyone needs to stop, pause and evaluate *why* these rules are being put in place.

So, what’s churning?

Churning is the practice of doing a bunch of trades in an investment account to simply generate fees for the adviser. It’s a practice that’s been frowned upon for decades, but it’s a fairly well-established understanding across the investment community with both advisers and clients. Advisers should make recommendations for transactions based on a client’s suitability, investment objectives, age, other investments, the client’s time horizon and willingness to accept risk. The practice of making a recommendation to generate a fee and “churn” an account is a known negative, and a fundamental part of the investment community.

What should you be doing?

Now is the opportunity to talk to your adviser about their investment philosophy and approach as well as how often they expect to be trading your account. You’re going to want to make sure your adviser has a definite opinion here and is able to give you a clear, confident answer. Find out if your adviser uses tools to model your account and create scenarios to test their investment hypothesis.

You should also be able to understand what your fee structure is. Are you paying per transaction, or are you being charged an annual fee irrespective of transactions? It's becoming more common that clients are paying an annual fee expressed as an annual percentage charged to their entire account balance. Paying an asset based fee brings to mind new concerns because you start to wonder what your adviser is doing every year to earn that fee. Can you recall any changes that were made to your portfolio in the last year or two? Did your adviser just set up your account and watch it? Did your account evolve as your needs changed?

The relationship you want with your adviser is one that is proactive to your financial needs, proactive to the market, proactive to the economy and has a fee structure that helps create a positive dynamic. As my account grows, the adviser fee grows. If my account shrinks, the adviser fee shrinks. That makes for a nice relationship. But now, reverse churning brings to light that advisers may make an investment change simply because they have to. Mandates may be put in place to force an adviser to make a move, not for their own benefit, but rather due to the fact that they are mandated to make moves every year to justify their annual fee. If broker dealers are seeing accounts without any activity, they notify the adviser who then will likely make an investment change suggestion to their clients despite market conditions or the financial situation of the client.

Churning and doing trades for the sole benefit to the adviser is an awful practice that can be relatively easy to spot. Reverse churning is more deceptive. Everyone should be aware of these new regulations so that as investment recommendations come through from your financial adviser you can know to ask yourself – are these suggestions made because my specific financial situation changed? Or, is it because it's been a while since anything was done in my account and my adviser needs to do something or be accused of reverse churning?

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