

# The principle of suitability

Contributed by Travis Morien

In America there is a consumer protection rule called the "Principle of Suitability". This means that if an adviser is going to sell you something he must make sure that the product suits your needs.

In Australia we have very similar legislation, but I prefer the American name for this rule as I think "suitability" communicates what we are talking about better than the "know your client rule" and "seller beware" rules that affect Australian advisers.

Advice should be given that is made specifically for a client. One of the reasons why I don't like dodgy gurus is that they don't bother with such a constraint. If you go to a seminar where they are flogging real estate or trading software there is never any real attempt to figure out what your needs and goals are, just a big sales pitch where they try to convince people that whatever their product is it suits anyone at any stage of their life.

In Australia we have "seller beware" legislation. A financial planner has to stand 100% behind the advice he or she gives, and it is up to the financial planner to make sure that the product suits you. Extensive fact-finding needs to be done and a variety of disclosure documents need to be signed by all parties involved, the sum total of which needs to form a very strong case that if taken to court will prove that the investment was appropriate for the client's needs.

Have you ever been to a guru seminar where this happened? Did they start out by making a statement that the product they are about to demonstrate carries a significant risk of causing capital loss and should not be purchased by anyone without ample spare cash to meet their daily needs and an investment time frame of many years? Did they find out what the audience wanted and make customised suggestions about how to deal with the situation?

This is really the difference between a credible financial adviser and a ripoff artist.

Financial planning is a sales based business, it would be very hard for an FP to keep a straight face and look anyone in the eye and say he or she wasn't selling some sort of product or service, but they must build a very strong case any time they make a recommendation. "Seller beware" means that the court will side automatically with the disgruntled client and the only way to avoid legal problems would be for the financial planner to provide as evidence a signed fact-finder sheet that includes notes about what the client was asking for and background information on the clients financial situation. The planner is presumed guilty if he doesn't have a paper trail that explains exactly why this product was recommended and not another one, and showing how the product meets the client's needs.

Whenever you seek financial advice from either a financial planner or some other adviser, ask yourself if this individual seems to be trying to push you into a particular product, or is this person working with you to find which ones are most suitable.

Most good financial advisers will give you plenty of background information on different investment alternatives, I start out many of my appointments with a 10 minute tutorial on the pros and cons of the different investment classes. Of course the adviser may be seeming to endorse certain approaches over others (I for example would recommend diversified shares funds for most people with a long term time frame), but beware if the guy seems to have nothing else up his sleeve.

Where a pros and cons tutorial differs from a ripoff artists modus operandi is that the ripoff artist seems to have nothing nice to say about any alternative investment, and only good things about their product. If you attend a seminar by a real estate agent, you probably won't hear a balanced view on the benefits of creating a portfolio involving shares and property, you'll hear horror stories about stock market crashes and soothing tales of how real estate has no real risk and grows steadily over time without a glitch. (This has been the case at the real estate seminars I have attended offered by real estate agents and The Investor's Club).

Going to a share trading seminar I heard about how risky fundamental analysis was and how one should never buy and hold, citing a variety of speculative stocks that went bust. Instead risk could supposedly be eliminated by maintaining a stop-loss sell order with your broker and relying on your high tech black box software. Who wouldn't benefit from share trading if this were true? The salesman said trading was a fifteen-minute-a-day business and the software along with the training they give could make anyone wealthy.

A proper adviser should tell you all about the risks of the recommended strategy. When I see clients and talk about shares portfolios, I whip out a poster showing the performance of the stock market for the last 100 years. I point out all the crashes along the way, looking them in the eye I tell them that despite the long term uptrend of the market and the great returns for those who held on, the stock market is not a place to be if you don't have the stomach to watch your portfolio fall 50% in a few months. If a real estate adviser is talking to someone he should probably show a chart of

interest rates and point out how quickly they can rise and how rapidly your cashflow could become unsustainably large and negative, also pointing out some statistics about occupancy rates in the area and a few comments on the inevitable encounter with the tenant from hell.

If your trading system really does have a downside risk of 5% per trade, you are still only 20 trades away from bankruptcy, and reasonable estimates about the size of drawdowns and number of negative trades, which relate to risk of ruin should be discussed. I saw no discussion of risk of ruin at the trading seminar I attended.