The Cost of 'Free' Financial Advice for Expats

Out at networking events, calling you at work or on your mobile, financial advisors seem surprisingly eager to provide you with *free* financial advice. These financial advisors offering free advice are actually paid commissions to sell financial products. In China, most financial advisors catering to expatriates are selling offshore investment/pension plans, also known as 'unit-linked life insurance' or 'portfolio bonds.'

Living in Shanghai, I have encountered a number of people that signed up for these investments, and they often had misconceptions about how their investments worked – particularly in regards to fees and taxes. They trusted their advisor to provide objective advice since they were 'independent.' The problem is that the more profitable a product is for a provider, the higher the commissions they pay advisors to recommend it. Charges tied to unit-linked life insurance and portfolio bonds are high, so insurance companies pay advisors high commissions to encourage their sale.

A few years ago, a friend of a friend (who I'll call Bill) was referred to one of these advisors, and signed up for a 25-year offshore investment plan. About a year later, Bill came across one of my articles, and saw that his advisor and I explained features of his investment very differently. To help make sense of it, Bill asked if we could meet to discuss the investment. The three of us eventually sat down together and talked about the tax implications, investment philosophy, and costs of Bill's plan. After our meeting, Bill had a much better understanding of his investment. By the end of this article, you will as well.

Tax Implications

Bill mistakenly assumed that these investments would grow and be tax free because they were held in 'tax havens' like the Isle of Man. He did not understand that tax treatment also depends on his nationality and where he lives. Bill told his advisor about his plans to leave China and return home in a few years, but his advisor did not explain what that would mean in regards to tax treatment – most likely because commissions create a strong financial incentive *not* to bring it up.

For Americans, these types of offshore investments are sometimes considered Passive Foreign Investment Companies (PFIC) by the IRS – and suffer punitive tax treatment. Fortunately Bill is not American, but he was still upset to learn that when he returns home with 20+ years left in the investment, his plan will no longer be tax-free, but will be tax deferred. When he takes distributions during retirement as he plans, he will owe tax on the offshore investment.

When confronted with this, Bill's advisor recommended that he stay in compliance with tax laws. Less scrupulous advisors claim that tax authorities cannot tax or pursue money they are unaware of, and that tax havens have a vested interest in keeping client information confidential. In other words, these 'advisors' are recommending that you break the law for decades with your life savings (ridiculous on numerous levels).

Cost and Returns

Aside from uncertain tax treatment, another problem is their cost – sometimes 5% a year, and sometimes *much*, *much* higher. When trying to figure out the cost, put aside marketing materials designed to make the investment look cheap, and add up all the fees for yourself. The best place to start is the fee schedule in the policy terms and conditions.

When confronted on the high ongoing fees, Bill's advisor asked if he would rather pay 1% for an 8% return, or 5% for a 15% return. If the insurance company could guarantee an annual 15% return, even I would sign up! The problem is that no one is guaranteeing 15%, and there is no grain of truth to the idea that higher fees increase your chances for higher returns. In fact, the only 'sure thing' when it comes to investing is cost – which is a direct drag on performance.

Bill's advisor claimed that with his guidance, Bill could ride bull markets higher while avoiding bear markets. The problem is that there is overwhelming evidence that market timing does not work over the long-run. Meeting quarterly with his advisor, Bill's portfolio was a hodgepodge of emerging market funds, a managed futures fund, and money frozen in a UK property fund going through problems.

'Aren't these good for *some* people in *some* situations?'

When clients sign up, these advisors can earn a commission of two percent or more of the plan's assumed contribution value for the full term… all upfront. Picking apart what these products truly cost, and considering that even a 2% difference in fees could make tax treatment irrelevant[1], I have trouble finding benefits for anyone other than the insurance companies and salesmen. Tax benefits (if any) and illusory bonuses are often quickly made irrelevant by a long list of fees.

After our meeting, Bill had a much more clear understanding of the tax treatment and fees associated with his 25-year investment plan. If he understood it from the beginning, he never would have signed up. When he saw what the plan cost him to get out, versus what it would cost him to keep for another 24 years, Bill decided to get out – and in doing so, surrendered his first year of contributions. It was an unpleasant situation to be in, but it was his best option once he had all the facts.

Bill now has his savings invested in a well diversified portfolio of low-cost funds in a regular brokerage account. Based on his current circumstances, his account is growing tax-free.[2] If he moves home or decides to live somewhere else, his flexibility is much greater as brokerage accounts do not have any long term contract, lock-up period, or surrender charge.

Offshore investment opportunities can sound incredibly attractive, but the rules of smart, responsible investing have not changed. Simplicity, cost efficiency, and flexibility are important principles to keep in mind no matter where you live.

[1] *Available upon request - an illustration regarding fees versus tax benefits.*

[2] ***Disclaimer****: This is based on Bill's situation and may not apply to you. All information and ideas should be discussed in detail with your individual advisor prior to implementation.*