Investors Lose Out When Advisors Use Soft Dollars

Often called “the investment industry’s answer to frequent-flyer miles,” soft dollar transactions allow managers to get luxury services, while investors foot the bill.

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Pervasive, but rarely mentioned, soft dollar transactions are an opaque and conflict-ridden practice that can lead to lower returns for investors.

A relatively hushed practice in asset management, soft dollars are benefits to an investment manager—broadly defined as “research”—that a broker provides in exchange for commission-generating trades.

Here’s an analogy. Imagine you’re mailing a letter to a relative across the country. How would you send it?
Would you consider buying the mailman a first-class plane ticket to deliver your letter, where he could enjoy a glass of champagne along the way?

As absurd is that may sound, some investors inadvertently do something similar when advisors execute trades on their behalf due to soft dollar transactions.

Recently, the EU moved to restrict these research benefits in European markets.

There's a smart reason why: Often called "the investment industry's answer to frequent-flyer miles," soft dollar transactions allow managers to get luxury services, while investors foot the bill. Even worse, most investors probably don't even know that it's happening.

As a smart investor, you should understand and look out for an investment manager's use of soft dollars.

Why Investors Should Pay Attention to Soft Dollars

Investment managers will route trades through high-commission brokerage channels—even though cheaper options are available—in order to gain free access to soft dollar benefits like industry reports, expensive data services, and even conference tickets.

They are called soft dollars because no cash is exchanged. Trades, which have value to the brokers executing them, are used as payment.

Soft dollar transactions can occur in two places: with your financial advisor and with investment funds, such as a mutual fund. Basically, anytime a financial professional has discretion to choose how to buy or sell shares, soft dollars could be in play.

According to the SEC, 42% of financial advisors and 40% of funds engage in soft dollar activities.

There are three major problems with this scenario that we should all be more aware of.

1. Lack of transparency

Unlike other investment expenses, which are generally clearly stated, the details of soft dollars transactions are not widely published.

Funds do not include soft dollars expenses as part of their expense ratios, and financial advisors only need to disclose if they use soft dollars, but they do not need to quantify the amount.

Instead, the cost of soft dollar transactions simply shows up in lower performance. High cost trades drag on returns, and many investors are none the wiser.

Additionally, an SEC study found that 28% of soft dollar benefits were being used for non-research products and services by advisors.

2. Drag on returns

Studies have shown that soft dollar trades result in higher execution costs, which hurt investor returns. Not only do soft dollar trades cost more in commissions, but they also tend to have more market impact.

John Haslem of University of Maryland found that the total trading cost for soft dollar transactions was approximately 0.30% higher than a full-service broker. The same study found that a 0.01% increase in brokerage commissions is associated with a decline of approximately 0.05% in fund returns.

3. Conflicts of interest

Soft dollars create new conflicts of interest.

Investment managers have discretion over how much to pay up for trading, as long as the manager determines that the rate is "reasonable in relation to the value of the brokerage or research services."

According to the Financial Industry Regulatory Authority (FINRA): "Because a manager can use client commission dollars to obtain research and other services that the manager otherwise would have to pay for from its own assets, there could be incentives for a manager to enter into brokerage arrangements that may not serve a client's best interests."

Such arrangements include: overpaying for trades, overpaying for research, and trading more often than is necessary in order to generate more soft dollar benefits. Additionally, mutual funds may use soft dollars generated from one fund to pay for services benefiting a different fund. In this case, investors in the first fund shoulder the cost of soft dollars, but do not receive any benefit.

Get Ahead as an Investor

It is difficult to actually quantify the impact that soft dollars may have on your portfolio, but if you know how the system works, you can begin to ask the right questions for yourself. Both financial advisors and fund managers can engage in soft dollar activities, so you should understand how they operate.

Financial advisors must disclose if they use soft dollars in their annual Form ADV filing. The SEC compiles a useful spreadsheet of all the registered investment advisors in the US and their current soft dollar status (see column labeled “8G1” which corresponds to the soft dollar question on Form ADV).

Investment fund companies are also required to disclose whether they use soft dollars. Unlike financial advisors,they also have to provide the dollar value of soft dollar transactions. This can be found in a fund’s supplemental Statement of Additional Information, or SAI, and is often labeled as “soft dollar brokerage” or “brokerage in exchange for research.”

In general, index funds and ETFs have not been using soft dollars. However, it’s never a bad idea to check your funds specifically.

If you had never heard of soft dollars before, you’re not alone. In an informal poll of industry veterans and coworkers in my 10+ years in finance, I’ve met very few people who are familiar with the practice.

Now, equipped with a working knowledge of soft dollars, their mechanics, and their impact on everyday investors, you can better evaluate an investment manager and make sure you are making the most of your money.