November 22, 2016

Does Your Fee Schedule Need an Overhaul?

The growth of the fee-based advice model has been one of the most significant developments in financial services over the last 30 years. We have gone from a world totally dominated by commissions to one where fee-based accounts are approaching $3 trillion in value. For the first time in history advisors now derive more revenue from fees than from commissions.

This trend will certainly continue. Brokers fleeing the wirehouses for a more client-focused environment will fuel its growth. The Labor Department's new fiduciary rule already has caused many brokerage firms to discontinue the use of commissions in retirement accounts. The Securities and Exchange Commission's own long-promised fiduciary rule will put further pressure on broker commissions in the future.

Remember, the Goal Is to Help Clients

The trend toward fee-based advice has been driven primarily by a desire to find a business model that removes some of the conflicts of interest inherent in the commission-based model. Compensating an advisor based on a percentage of assets under management removes the incentive to recommend unnecessary trades solely for the purpose of generating a commission.

But charging for advice based on a percentage of assets under management does not perfectly align an advisor's interests with the client's. For example, it may be in a client's best interest to liquidate a portion of investments to pay off a mortgage, but it is certainly not in the advisor's financial interest. Will this affect the advisor's advice?

The AUM pricing model also holds a more subtle potential conflict. Paying an advisor more as an account grows could cause the advisor to take greater risk in order to generate greater returns. The SEC has always identified this as a potential problem with performance-based fees, but the same potential exists with the AUM pricing model.

The AUM pricing model has an even more fundamental problem: It can sometimes be hard to reconcile the fee charged with the services provided.

A recent Dilbert cartoon makes the point. Dogbert says to his client, Wally, "I'll manage your portfolio for a standard industry fee of 1% per year." Wally replies, "I'm investing a billion dollars. Your fee would be $10 million per year."

Dogbert responds, "Those index funds aren't going to pick themselves."

Firms that provide services in addition to asset management have a much easier time rationalizing an AUM pricing model. For example, firms that offer financial planning services often see a direct correlation between the size of the client and the amount of work required to service the client. Larger estates frequently come with greater complexity.

Firms that focus solely on providing asset management services have a harder time justifying an AUM pricing model. With today's technology there is really no more work involved in managing

a $1 million account than a $100,000 account. Back in the days of manual trading and individually handcrafted portfolios, advisors could rationalize AUM pricing, but not in today's era of automated trading and model portfolios.

A common defense of the AUM pricing model is that it puts advisor and client on the same side of the table. There is a surface appeal to this argument—the advisor's fortunes do rise and fall with the client's. But it also suggests that linking their fates will cause the advisor to work harder or do more for the client.

The reality is that the market determines most of the rising and falling and it is not within the advisor's control. Plus, it raises the question of why the advisor isn't doing his or her best for the client without need of an incentive payment.

Is There a Better Way?

Fee-based advisors in increasing numbers are grappling with these issues and some are migrating to hourly or retainer-based fees. These alternative fee models seek to deal with some of the potential conflicts of interest inherent in the AUM pricing model and provide a more rational connection to the service provided and the fee charged.

But do they? Is there such a thing as a conflict-free fee schedule? When I practiced law many years ago fees were usually charged on an hourly basis and I witnessed many abuses as young associates struggled to reach their quota of billable hours.

Whenever money is exchanged in return for services there is the potential for chicanery.

Some industry observers question the viability of advisory businesses that charge on an hourly or retainer basis. But a growing number of firms prove this business model is quite viable. And going back to my law firm days again, I can tell you that we lived quite well off of hourly fees and retainers. You simply have to set your fees at an appropriate level.

Perhaps the real fear among some advisors about hourly and retainer-based fees is their transparency. The client sees very clearly what they pay for advisory services. In contrast, the AUM pricing model has a way of masking fees by translating them into mysterious units called "basis points."

Our firm has tried to address these problems by developing a hybrid of the AUM and retainer-based pricing models. We charge a percentage of assets under management up to a certain asset level and then cap the annual investment management fee. Once the account reaches the cap, the client pays a flat annual fee no matter how large the account becomes.

The evolution of the fee-based model will, no doubt, continue, but the truth is, there is no such thing as the perfect fee schedule. Well-intentioned advisors can serve their clients' needs well using commissions, AUM pricing, hourly/retainer-based pricing or a combination of all of them.

The "best" pricing model depends on the particular situation and the needs of the client.

A New World of Pricing

We are entering a new era where client sensitivity to, and government scrutiny of, fees will be ever increasing. You can see it in the move to passive investment strategies, the DOL's fiduciary

regulations and low pricing offered by robo-advisors. You can also see it in the industry's own efforts to seek out alternative pricing models.

Many clients today are clueless about the fees they pay. Some still believe their broker works for free because fees are so well hidden. But those days are rapidly coming to an end; the Internet has increased fee transparency and the financial press has focused on the importance of fees and one of the few things that investors can control.

We will all be held accountable for the compensation we receive. And the focus will be less on the structure of our fee schedule—commissions vs. AUM pricing vs. hourly vs. retainers—and more on the impact our fee schedules have on our clients in specific situations.

You can see this in the new DOL fiduciary rules. The rules go into excruciating detail on the impact various fee structures have on the best interests of the client. Don't think for a moment that you are immune from scrutiny simply because you are a fee-based advisor. It may be a government regulator or it may be your clients asking the questions, but we all need to justify our fees in the context of how they apply to our clients in specific situations.

You can wait until you are forced to defend how you charge clients, or you can get ahead of the issue. Now is the time to re-examine your fee schedule and its impact on each of your clients. Your fees don't need to be rock bottom. It is still acceptable to charge premium prices for premium service. But you should be able to demonstrate a reasonable relationship between the fees charged and the services delivered. Can you justify your fees in terms of the value you provide your clients? Saying "Those index funds won't pick themselves," won't cut it.