Five Reasons Your Asset-Based Fee Model Won't Survive

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The advisory business is changing rapidly. Your fees will be a subject of continuing scrutiny. Here are five reasons why the asset-based fee model won't survive:

1. **It carries an undisclosed conflict of interest**

In *SEC v. Capital Gains Research Bureau, Inc.,* decided in 1963*,* the U.S. Supreme Court held that Congress, in enacting the Investment Advisers Act of 1940, intended "to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser – consciously *or unconsciously* – to render advice which was not disinterested." It further held that investors "must . . . be permitted to evaluate overlapping motivations, through appropriate disclosure, in deciding whether an adviser is serving 'two masters' or only one, 'especially . . . if one of the masters happens to be economic self-interest."

When an advisor provides financial planning and investment management advice, and calculates its fee on assets under management, it has an inherent conflict of interest. Its economic interest is served by increasing assets under management. Its financial planning advice is rife with issues where a recommendation would reduce assets under management. These issues include whether to pay off a mortgage, whether to purchase more life insurance and whether to purchase a deferred-income annuity (longevity insurance), among many others.

As recently as February 26, 2015, in a speech to the IA Watch 17th Annual IA Compliance Conference, Julie M. Riewe, co-chief, asset management unit, division of enforcement of the SEC stated: "An adviser's failure to disclose conflicts of interest to clients subjects it to possible enforcement action. Because disinterested investment advice – or, alternatively, clients' knowledge of any conflicts that might render their adviser's advice not disinterested – is at the heart of advisers' fiduciary relationship with clients."

I reached out to Knut A. Rostad, president of the Institute for the Fiduciary Standard. I asked him whether an advisory firm that provides both investment management and financial planning services, and charges a fee based on AUM, is required to disclose the potential conflict of interest. His response was an unequivocal "yes."

Do you really want to continue with a fee model that requires you to make this disclosure?

2. **It's not transparent**

Most advisors who provide investment management and financial planning services charge a bundled, asset-based fee.

Bundling fees is the problem many of these same advisors rail against with 401(k) providers, who package administration, recordkeeping, custody, investments and investor education as one fee.

Bundled advisory fees don't permit clients to understand how much they're being charged for investment management and for financial planning so they can determine if these fees are reasonable or competitive.

Clients would be justified in insisting on a higher standard of transparency from advisors who extoll the virtue of their fiduciary relationship with them.

3. **It isn't competitive**

Congratulations. You've just landed a $5 million client who is nearing retirement. You reviewed her portfolio and recommended a different asset allocation. You presented her with a proposed portfolio of low-management-fee index funds, and carefully explained the historical risk and returns of this portfolio

You also prepared a comprehensive financial plan. It's a holistic plan that reviews all aspects of her financial life, including cash flow, debt strategies, rent versus buy analysis, investment analysis, insurance coverage, saving for retirement, when to take Social Security, withdrawal strategies, income tax strategies and an estate plan review, including family and charitable gifting ideas.

You provide an annual review to be sure the plan is being followed. You also rebalance the portfolio to keep her risk profile intact.

Your asset-based fee for these services is 0.50% annually, which is $25,000 based on the present value of the portfolio. Over time, it's likely to increase.

If your client went to Vanguard directly and used its Personal Advisor Services, it would pay 0.30% annually ($15,000). The Vanguard advisor will create, according to Vanguard's web site, a "custom tailored financial plan," put the plan into action and manage the portfolio, while also working with the client to keep track of the plan's progress, and rebalance the portfolio when necessary.

An even more cost-effective option would be for the client to use a financial planner who will tell her exactly how to invest on her own, and will provide a financial plan for a fee. Anna Sergunina, CFP, at MainStreet Financial Planning, is one of many advisors offering this service.

MainStreet will prepare the comprehensive financial plan described above for an average fee of $4,200. It will include detailed investment recommendations the client can implement herself using Vanguard or another low-cost fund family. The fee includes assistance with implementation of the recommendations, free questions for 12 months, and a 6-month check-up session. Annual check-ups are $1,600. Portfolio rebalancing is available for $750 per session.

MainStreet is a member of the Garrett Planning Network. Members of this network are financial planners who are independently registered investment advisors and meet Garrett's participation standards. They agree to adhere to the CFP Board Code of Ethics and Practice Standards and the National Association of Personal Financial Advisors Fiduciary Oath. Many (like MainStreet) don't manage money and limit their services to the preparation of financial plans, on an hourly or flat fee basis.

Just because there are lower-fee options available doesn't mean you have to match them. But, in this Internet age, your client is likely to uncover them, which can lead to an uncomfortable conversation -- at best.

The availability of far more competitive alternatives raises other issues. How sound is a fee model that relies on the lack of knowledge of your clients about lower cost options? How comfortable are you advising your clients about the importance of keeping fees and costs low, while charging fees for financial planning that may be excessive? Is this consistent with your fiduciary obligation to your clients?

4. **Unbundling is a viable alternative**

Advisory firms are being told to better quantify the value of financial planning. A recent paper made a strong case for the additional value of "more intelligent financial planning decisions." Few would argue with this premise, but it doesn't address the problem of assuming an asset-based fee is the most cost-effective way for investors to obtain that value.

Derek Tinnin, CFP, the co-founder of Altiora Group, LLC, a wealth-consulting firm, doesn't believe it is. Altiora manages money, provides income tax services (including the preparation and filing of federal, state and local returns using in-house Certified Public Accountants), does comprehensive financial planning and offers personal CFO services.

It uses unbundled, flat-fee pricing that emphasizes providing advice and personal service rather than gathering assets under management. Portfolio size is not part of its pricing equation. It sets forth its fees on its web page.

5. **Fee pressure will continue to mount**

Increased competition from an ever-growing list of robo-advisors and the entry of major fund families into the robo-advisor business makes it likely fees for advisory services will continue to decline. This is precisely what occurred when competition for index funds increased. Fees on stock index funds decreased by 56% from 2000 to 2013, and are continuing to decline.

Traditional advisors are responding by attempting to justify their asset-based fees. A better alternative is to unbundle your fees and charge based on the time, effort, complexity and value of your services.

If you don't make this choice now, the market may make it for you.

Dan Solin is a New York Times *best-selling author of the* Smartest *series of books. His latest book is* The Smartest Sales Book You'll Ever Read*. His sales coaching practice has expanded to include advisory and non-advisory firms in the United States and Canada and includes individual and group coaching via video platforms. Dan is no longer affiliated with any advisory firm. Get Dan's investing insights by signing up for his free, weekly newsletter* here.