

Fee-Only, Fee-Based or Commissions: How Should You Pay Your Financial Advisor

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There has been a long standing debate whether investors should pay for financial services with fees or commissions. The right answer may not be one or the other, but which one is better for each individual client. After all, it's not how an investor pays for the services that really matters, it's how much was paid, and what value was received.

According to the Securities Exchange Commission¹, each compensation method has potential benefits and possible drawbacks, depending on the client's individual needs. Thus, advisors using either method exclusively may not be working in their client's best interests.

Simple math shows that paying a one-time 5% commission, or even infrequent trading commissions, may be much less expensive than paying 2 or 3% per year for the number of years that an investment is owned. In some cases, paying commissions is considerably less than paying on-going fees.

To determine which method is best for you, you must add all of the costs associated with owning the investments for your planned holding period for each fee method. Comparing these total fees will provide you with the answer. This exercise is no different than comparing mortgage or car loans. All costs must be included.

But remember that costs are only one component of an investment program. Low costs for a poor performing investment is no deal either. You should also consider if the investment program will help you efficiently reach your financial goals within your risk parameters, time horizon, etc.

Investors should be wary of Fee-Only and Fee-Based Advisors that recommend mutual funds. Their marketing rhetoric usually centers on their "superior" compensation method. This is very misleading because these advisors, knowingly or unknowingly, may be doing financial harm to their unsuspecting clients. This is because mutual funds do not readily disclose all of the fees an investor pays. This allows for the true fees to be misquoted. For example, if an advisor charges a client 1% and the disclosed mutual fund fees are 1%, the advisor may state that their clients are charged 2%. However, this is incorrect because additional mutual fund fees, such as trading costs, must also be added to the total fee. In this case, 1% in trading fees would bring the clients' total fee to 3% per year.

This may be a very costly problem for larger investors because the internal mutual fund fees are fixed, forcing a large investor to unknowingly pay substantially more than other investors. For larger investors, other alternatives, such as lower cost Separately Managed Accounts (SMA), should be considered. See *the White Paper "Hidden Mutual Fund Costs"*.

In my 25 years in the financial services industry, I have seen or heard about some very interesting, albeit deceptive, marketing conducted by advisors regarding their compensation. An example would be the Fee-Based advisor who boasted very low advisory fees. However, after closer examination, it was discovered that the fees were based on a client's total net worth. Imagine how you would feel if you were paying annual advisory fees on your car or lawn mower. Or the Fee-Only advisor that used "institutional" mutual funds that had lower internal fees than the average "retail" mutual fund. Unfortunately for this advisor's clients, their "lower" annual internal mutual fund fees were still over 2%. Or the advisor who referred insurance business to an "outside" insurance agent. The advisor stated that he didn't receive any of the insurance commissions. However, the commissions were actually paid into a holding company, and the advisor and the insurance agent were the only shareholders of the company. The insurance "commissions" were then paid to both shareholders equally as "cash dividends" of the company.

Some advisors also have financial or referral based arrangements with other financial services providers, such as mortgage brokers, tax advisors, etc., in an effort to obtain information on potential clients. By agreeing to use the services of both, the investor could receive a reduction in fees. Passing on the questionable ethics of such an arrangement, it is questionable if the client would receive the best investment products or services.

In the ideal world, to be free of conflicts-of-interest, Financial Planners should be paid only for constructing a financial plan along with future follow-ups. Investment Advisors should be paid for executing and monitoring the investment plan. Regardless of the compensation method utilized, this is a potential conflict-of-interest. After all, wouldn't you question the recommendations of a cardiologist who was also the heart surgeon?

It is obvious that all three methods of compensation can be abused. The Fee-Only, the Fee-Based and the Compensation advisors are all paid only if the recommended business is done through them. An ethical advisor will utilize whichever method is best for their clients. Using only one method eliminates choices. Much like hiring a carpenter that only has a hammer!

Therefore, the most important elements in the advisor-client relationship are integrity and trust. So, as a starting point, when looking for an investment advisor or financial planner it would be wise to:

- Work with an acknowledged fiduciary. Fiduciaries have a legal duty to always act in their clients' best interest.
- Adhere to the "Trust with Verification" rule and always verify what you are told by the advisor, regardless of their experience, credentials, referral source or firm status.
- Do not put much emphasis on advisors that promote client referrals or blind referral programs as any unhappy client is usually an ex-client and is not in the referral database.
- Always use the services of a 3rd party custodian, make deposits directly to the custodian, and obtain statements directly from the custodian.

The bottom line, put some time into finding the right planner or advisor. And don't fall prey to all the marketing hype.

¹<http://www.sec.gov/investor/pubs/invadvisers.htm>

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