

**Advice the American way; For some clients, commissions are the best choice, for others, fees are the favoured option. In the US, where there has been a move towards fee-based advice for the past 10 years, the debate and evolution goes on.**

Investment Adviser; 8/26/2002

by Bob Barry

The Financial Services Authority (FSA) (UK) proposals to push independent financial advisers into a "defined payment," or fee-based system, is no doubt unsettling for advisers who have earned commission on products they sell.

What impact would Consultation Paper 121 have on profitability? Would the public be willing to pay fees? What impact would it have on the relationship between advisers and their clients, and between advisers and their product intermediaries? How would it affect the quality of advice? In short, can Independent Financial Advisors (IFA) survive under this system?

A look at the US experience, where many financial planners have voluntarily shifted to a fee-based model in the past decade, may prove instructive.

First, it is important to understand that the fee-versus commission re-numeration issue in the US has been hotly debated for nearly a quarter of a century, and it remains far from resolved. Planners continue to experiment with different forms of re-numeration, driven by public demand, the investment markets, a search for stable income, and by debate within the financial planning profession. Note that government mandate is missing from this list.

Although federal and state regulators and legislators periodically eye the compensation controversy, they have yet to regulate compensation except indirectly through such avenues of disclosure.

Second, it is important to understand that regardless of how they are compensated, genuine financial planners in the US focus first and foremost on the overall financial interests of their clients.

A planner may be compensated primarily from the sale of securities or fees from assets under management, but the planner will work with his clients on a broad scope of concerns well beyond investments, ranging from setting client goals and budgeting, to assessing insurance needs, helping clients plan for their retirement, and designing an estate plan.

## **Figures**

Some numbers on compensation might be useful. Although the figures vary slightly from study to study, roughly 40 per cent of Certified Financial Planner certificants in the US, the most respected and widely used financial planning certification in the US and the world, use a fee-and-commission combination.

While some planners employ a fee-offset approach similar to the model proposed by the FSA, most planners who use this arrangement keep them separate. For example, a planner might charge a fee to prepare an overall financial plan for a client, and later receive commissions from the sale of products to implement that plan.

About 25 per cent of planners work strictly on commissions. Close to another 25 per cent work on a fee-only basis, though fee-only can take several forms: assets under management (mutual funds are popular with US planners), an hourly fee, unbundled project fees or an annual retainer. About 10 per cent of planners are salaried. This division of compensation was not always the norm.

Commissions dominated during the financial planning professions early years, starting in the late 1960s and early 1970s, primarily from the sale of insurance products (especially life and annuities) and to a lesser extent, securities.

Declining interest rates, which seriously undermined the high-return illustrations of policies sold, and changes in the tax code took the steam out of insurance sales.

## **Sales**

Many planners turned to collecting commissions from the sale of limited partnerships interests, such as real estate and oil and gas. But the collapse of real estate and the oil and gas market in the mid 1980s, exacerbated by major changes in the US tax code in 1986, put a damper on LPs. The collapse of the limited partnership market left a bad taste in the mouth of many financial planners and the public.

Commission planners began taking a lot of heat from consumer groups and the financial press, with complaints of biased advice and conflicts of interest. The public picked up on these arguments and began selecting more fee-based planners.

The trend towards fees began to accelerate in the 1990s, in no small part from pressure within the financial planning community itself.

Fee-oriented planners argued that client trust is what separates true financial planners from the rest of the transaction-oriented financial marketplace, and the only way to build that trust was to base your practice on fees, not commissions, because it "put you on the same side of the table as your client".

Proponents also argued that a fee-based practice provides a more stable stream of income and that long-term, recurring fee income that is not dependent on making new sales increases a business value should the owner want to sell the practice an argument especially appealing as the first wave of pioneer financial planners began thinking of retirement.

During the 1990s, assets under management, in which the planner earned a fee (perhaps 1 to 2 per cent annually, billed quarterly) based on managing liquid assets, became an especially popular method for collecting fees.

The booming stock market made it financially attractive and viable for many planners to convert from commission-based to fee-based advice. As you might expect and perhaps fear this transition from a commission-based to a fee-based practice has not always been an easy one for either the planner or the clients. Planners making the transition typically report an initial decline in income sometimes a significant decline particularly if they move into a pure-fee model. But most also report a return to what they were making solely by commissions within two to three years, and some do just as well in the first year.

More importantly, many planners report that in time they make more in fee income than what they would have through commissions.

### **Switch**

Most planners also report that their clients have generally approved of the switch and have remained as clients.

The US financial services industry has also had to go through a transition to accommodate the migration to fee-based. While no-load mutual funds have long been available, brokerage firms and other services have had to respond by providing other no-load or low-load products such as insurance and even retirement plans, and custodial and reporting services, though there is still a considerable way to go in some areas. Although many observers believe the profession will continue to move towards fees, primarily because the public overwhelmingly favours this, a fee-based system still faces challenges.

As with commissions, it is not immune to conflict of interests, argue some observers, particularly the assets-under-management model.

A planner may try to persuade clients to invest cash when some of that money might be better spent on long-term-care insurance or paying off excessive debt, neither of which will earn the planner a fee.

The slumping stock market has also forced some performance-based fee-only planners to examine fee alternatives that eliminate some of the perceived conflict-of-interests while at the same time providing greater stability of income (an issue that commission-only planners also face in volatile markets).

Some planners now charge a flat retainer fee based on the complexity of a clients needs, an approach that avoids the volatility of the market.

Others charge by the hour. This is especially popular among planners working with middle-income clients.

Some planners are even turning toward fees based on a clients net worth, rather than just managed liquid assets.

## **Reflective**

They like this because it more accurately reflects the comprehensive work they do for clients, it eliminates the incentive to keep captured assets just for the fees, and it avoids the impression generated by the assets-under-management approach that financial planners only do investments. A final significant factor affecting the fee-versus-commission debate is the commoditisation of investment services. Heavy institutional competition, driven by the internet, has pressured downward fees and commissions based on investment management. This has forced financial planners to reemphasise the value-added component that has always been at the root of financial planning in the US: comprehensive planning, of which investing is only one part.

Ultimately, many financial planners, including the Financial Planning Association, which represents CFP professionals, argue that the compensation issue should not be about fee versus commission, but about full disclosure to the consumer about how the planner is paid and any potential conflicts of interest.

For some consumers, commissions are the best choice, for others, fees work the best. In the US, the debate and evolution goes on.

Bob Barry is president of the US Financial Planning Association  
COPYRIGHT 2002 FT Business