
# YOUR CONSUMER GUIDE

# TO FEE-BASED FINANCIAL ADVICE

What are the advantages?
How much does it cost?

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## INTRODUCTION

Independent financial planners and advisors may be compensated in several ways: by commissions, on a fee basis, or by a salary plus bonus, similar to those advisors employed by the banks. The difficulty in assessing a potential financial advisor is in understanding: (1) the cost, and (2) how your advisor's compensation affects their services.

However the advisor is compensated, it is most important that the first meeting has full disclosure of the services being provided, the cost to you, how the financial advisor is compensated, and any potential conflicts of interest. This is typically done in a *letter of engagement and disclosure*.

Though only a small minority[1] of financial planners and advisors are delivering their services on a fee basis, there is a growing recognition in the industry that this model helps reduce (not eliminate) conflicts of interest in an advisor-client relationship. This paper examines the type of fees available and the ranges you can expect to encounter.

## ADVANTAGES OF DEALING WITH A FEE ADVISOR

When hiring a financial advisor you are looking for someone who is going to give you sound advice. The problem with the commission model is that your advisor is not paid to provide advice, but to sell you products. It becomes difficult to assess the value of advice if your advisor is being compensated by a financial services company whose profit is based on selling a particular investment or insurance product.

Even the most professional financial advisor finds that being paid by commissions can bias their advice, and a year 2000 survey[2] found the overriding reason advisors convert from a commission to a fee model was to eliminate conflicts of interest.

The main advantage of fee-based is this: if your advisor is paid the same fee by you no matter which strategy or investment they recommend, then they will put your interest ahead of their own. They are now working for you.

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[1] There is no central body that monitors financial planner compensation, though the Financial Planners Standards Council reports only 9% of Certified Financial Planners (CFP) in 2005 were compensated mostly by fees. Other industry surveys always yield a smaller number.

[2] *Investment Executive* Survey: On the Side of the Client, Ryan Jennings

There are other advantages, too. First, fees are easy to understand. They also offer, for the most part, greater transparency.

Second, fee advisors must deliver advice that you truly value and provide a high degree of service in order to retain you as a long-term client. That's because they are easy to fire. The lead time needed to give a notice of termination is usually included in your letter of engagement (0 to 3 months). You don't have to worry about back-end load commissions or deferred sales charges.

Third, fee advisors may have access to a larger selection of products. Some financial services companies don't offer a built-in commission option, so they would not be included on a commission advisor's product shelf.

Like your physician, a fee advisor is paid to provide you consultative advice. Like a pharmacist, a commission advisor is paid to provide you a product.

## WHAT EXACTLY AM I GETTING FOR MY MONEY?

Hiring a financial advisor is not like choosing a dentist. Dentistry is a much older profession whose members deliver a standard service. Professional financial advice, on the other hand, can mean different things to different people. So comparing one advisor to another is not as straightforward as choosing a dentist because their office is close to your home. In fact the title *financial advisor* and *financial planner* are often used interchangeably and have no standard definition.

The second issue when assessing an advisor is understanding what services you will be receiving and, just as important, the frequency of delivery. Some advisors also have what is called a tiered level of services, meaning the more revenue generated from you as a client, the more services you will receive.

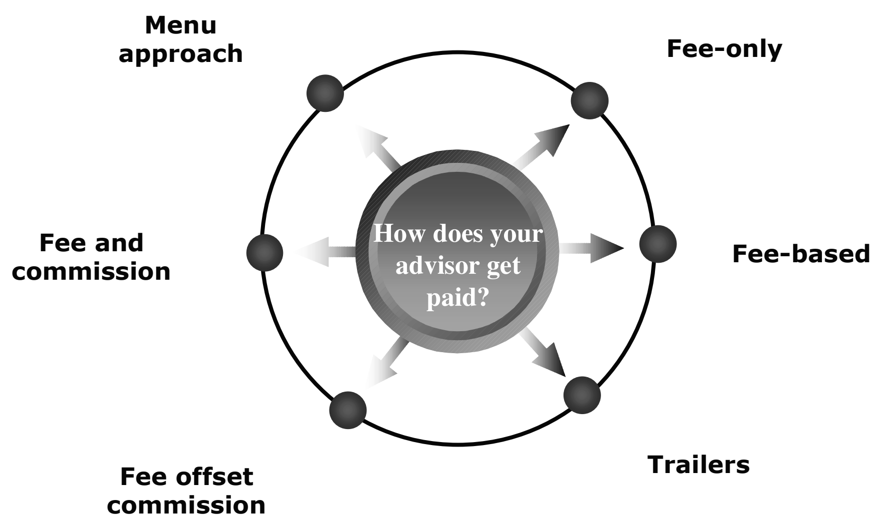
The table below describes the services delivered by advisors, both fee and commission, and the proportion of their clients receiving the service.

| PLANNING SERVICE[3]: | Percentage of Advisors who Offer the Service 2005 | 2004 | Average Proportion of Client Base Receiving the Service 2005 | 2004 |
|---|---|---|---|---|
| Annual financial plan review | 93 | 93 | 57 | 57 |
| Succession or estate planning | 77 | 82 | 30 | 37 |
| Formal written financial plan | 71 | 79 | 36 | 39 |
| Tax advice | 69 | 71 | 41 | 44 |
| Lifestyle planning | 55 | 65 | 34 | 37 |

## HOW MUCH DOES IT COST?

Unlike the U.S., there is no central body that regulates the term "fees" in Canada. So again, when interviewing potential advisors make sure you get a clear definition.

Here are the common fee models available to financial advisors with examples of the cost:




- **Fee-only**

A fee paid directly by you for services rendered. Generally does not involve any product placement. This fee can either be hourly, a flat fee, or an annual fee.

1. Hourly fees are dependent on the financial advisor's level of experience and overhead expenses. These can range anywhere

[3] Advisor perception study (which includes both fee and commission advisors), Environics Research Group, 2005

from $50 to $400 an hour. It is generally a good idea to agree on an estimate and a maximum number of hours at the beginning of the engagement. Exceeding the latter should require your approval.

2. Flat fees are generally assessed based on the advisor's estimate of the time and work involved. Comprehensive financial plans, which can take between ten and twenty hours, will take more time than a retirement plan. A young couple starting out will take less time than the owner of a large business.

   Fees can be as low as $150 for a templated financial plan, all the way up to $10,000 for the most complex. The average flat fee for creating a financial plan in Canada is $1,400, with $750 for updating an existing financial plan[4].

   Alternatively fees can be based on other factors such as a percentage of household income or net worth. Examples would be 1% of household income or 0.5% of net worth. There may also be a minimum fee.

3. Annual fees are the most difficult to compare since you have to make sure you are comparing apples to apples. There could be a fee for ongoing services that may include financial planning, tax planning and preparation, and some form of investment management and reporting.

   Fees are billed either annually or quarterly in advance, or monthly through pre-authorized withdrawal. Fees also tend to be higher in the first year (sometimes double) since the initial comprehensive financial plan tends to be the largest piece of work in the engagement.

   Again the range can be quite wide with fees as low as $250 up to $10,000 a year. As an example, one firm charges their Emerging Affluent[5] clients an average of $1,000 a year, and another firm charges their High Net Worth[6] clients an average of $2,500 to $5,000 a year.

[4] Your practice and profitability, AIM Trimark, Based on research by Advisor Impact Inc. Special supplement to *Investment Executive*, September 2004
[5] Have investable assets between $100,000 - $1M
[6] Have investable assets over $1M

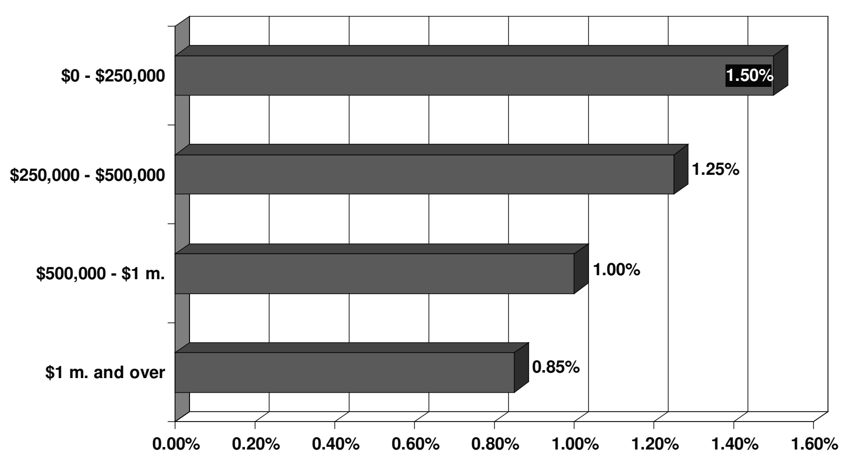
- **Fee-based**

A fee that is based on a percentage of assets under management paid either directly by you or more commonly deducted from your assets. This is the most common fee that advisors charge, either on its own or in combination with another fee. This fee is charged regardless of investment performance.

The service typically associated with this type of fee is investment management and/or investment counselling, but may include additional services such as financial planning and tax advice.

This fee can be a fixed percentage of assets (sometimes called basis-point) but is more commonly tiered. In a tiered (or regressive) percentage of assets fee, the percentage charged decreases as your assets under management with an advisor increase. Whether it is a fixed fee or tiered fee, there is usually a minimum asset requirement or a minimum fee for this type of arrangement.

**Tiered Fee Example**




What are important to understand in this type of arrangement are the fees on top of other fees. You may be paying for certain services from your advisor, but those services may be charged on top of portfolio management fees, mutual fund management fees, administration expenses, and trading costs. Have a clear understanding of all the fees involved before choosing this type of arrangement.

The final fee-based alternative is an all-encompassing fee or wrap fee. In this case there is only one fee charged, though it sometimes can start as high as 3%.

- **Trailer or service fees**

These are annual fees paid to your financial advisor by a financial services company that offers an investment product, such as a mutual fund. Trailer fees are included in the quoted management and expenses cost (MER) of that product.

In the case of mutual funds, equity mutual funds normally pay 1% of assets to your advisor, bond funds pay 0.5%, and money market funds pay 0.25%. If you purchased mutual funds on a back-end load or deferred sales charge (DSC) basis, your advisor would also receive a commission of up to 5% of your initial investment, but the annual service fees would typically be half those quoted above.

The percentage amount of service fee is generally standard from company to company, although you will find the occasional exception that will be slightly higher than the industry average. As well, most traditional no-load (no commission) mutual fund companies also pay a service fee, though there are still a few that pay a much smaller amount than average or none at all.

Since the year 2000, a number of mutual fund companies have introduced the F-class version of their most popular mutual funds. This class of mutual funds has a lower MER than the standard A-class versions because there is no trailer fee paid to the advisor[7].

- **Performance-based fee**

A fee based on investment gains, typically charged on the amount above an agreed-upon threshold. This type of fee is rare.

For example, suppose the threshold is 8%, and the performance fee is 25%. Then, if performance exceeded an 8% rate of return on an annual basis, a performance fee would be charged at 25% of the rate of return above 8%.

[7] The A stands for advisor and the F stands for fee.

- **Commission offset**

A flat or hourly fee charged for a financial plan, but this fee will be offset or completely eliminated by any commissions earned on implementation of the plan.

As an example, you and your financial advisor agree on $1,500 to produce a financial plan. Once you have reviewed and approved it, you decided to implement it through the same financial advisor. The financial advisor then collects a commission of $2,000 by investing your money. Because the commission is greater than the flat fee, the flat fee is refunded to you. Generally commissions greater than the flat fee are not rebated.

- **Fee and commission**

Same as above except the fee is not offset by the commission. There are typically two scenarios when this would happen:

1. A fee and commission advisor will charge you for an initial financial plan and collect a commission if you implement the plan through them. The advantage to paying a fee for the initial advice is that the advisor needs to be compensated for that work but is not under pressure to sell you something.

2. A fee-based advisor will recommend a product such as life insurance[8], but a fee-based or no-load option is not available. Your advisor will disclose the commission to you and you can decide to either purchase it through them or, if you are uncomfortable with your advisor collecting a commission, be referred to another advisor.

The largest segment of Certified Financial Planners in both the U.S. and the U.K. work on a mixed fee and commission basis. Either clients are offered a choice or the advisor charges the most appropriate compensation model for the service requested.

Surprisingly an Australian study that measures the quality of financial planning advice through the use of secret shoppers found that fee and commission advisors scored slightly higher than fee-only advisors, who together scored higher than commission-only advisors[9].

[8] There is no such thing as no-commission insurance sold through the advisor channel in Canada.
[9] Survey on the quality of financial planning advice, ASIC research report, Australian Securities & Investment Commission, February 2003

- **Menu approach**

It is actually not a bad idea for your financial advisor to have a menu approach to fees. That way you can pick your preferred method. Unfortunately, most financial advisors may offer only one or two methods, either by design or because they feel those are the most appropriate for the service you are seeking.

If there is a choice, you will be discouraged from changing fee methods in the middle of an engagement because of the increase in administration.

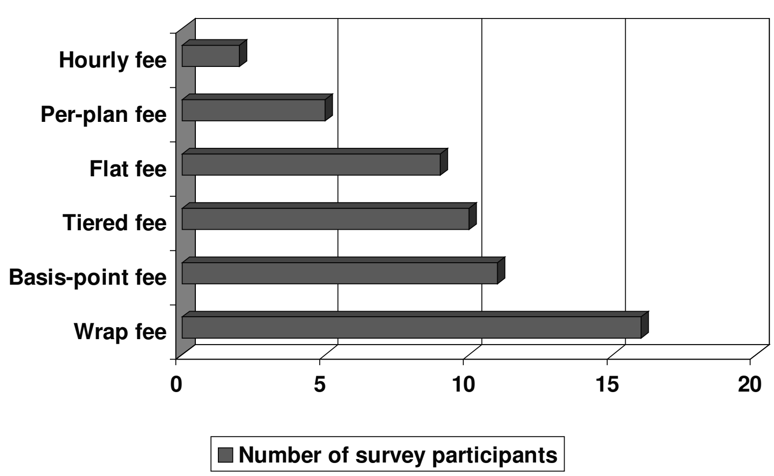
A mix and match combination of some and/or all the above may also be appropriate. It is not uncommon for advisors to unbundle planning fees and investment management fees.

This may take a couple of different forms:

1. A flat fee for financial planning and tax advice, plus a percentage of assets for investment management.

2. A two-tiered percentage of assets. A lower one for just investment management, and a higher one if you also want financial planning advice.

**WHAT FEE METHODS DO MOST ADVISORS OFFER?**

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Source: PricewaterhouseCoopers

**Percentage of Assets Pros & Cons**

The trend in the industry is definitely in favor of some form of fee-based percentage of assets[10]. The most common methods are a wrap or all encompassing fee, basis-point fee (a straight percentage of assets), and tiered fee based on percentage of assets.

The advantages here are: (1) there is a built-in incentive for your advisor to grow your assets, (2) the fees are typically deducted from the assets, which means you are not out-of-pocket, and (3) the fees are transparent compared to an A-class mutual fund.

The disadvantages include: (1) the minimum asset or fee requirement may eliminate middle-class clients from this model, and (2) there may be a bias on the part of the advisor in favor of managing assets as opposed to, say, encouraging you to pay down debt.

**Flat Fee Pros & Cons**

There still are a number of firms, though harder to find, that will offer a flat fee arrangement. Some clients prefer the flat fee because it puts a cap on the advisor's compensation, addressing the concern that fee-based advisors are only concerned about gathering assets to grow their business.

The disadvantages include the lack of an incentive for the financial advice to succeed and a bias toward trying to do the work as quickly as possible or even to do the bare minimum required. With a reccurring annual fee, however, client retention is the incentive to do a good job.

**Hourly Fee Pros & Cons**

An hourly fee is the least popular method. Even among fee advisors, it tends to represent less than 5% of their compensation. Hourly tends to work best for short engagements such as when someone just wants to get some financial counselling or a modular financial plan such as a retirement plan. Hourly fees are: (1) easy to understand, (2) easy to cost manage by self-regulating how much advice you need, and (3) there is no long-term commitment.

[10] Canadian Wealth Management Survey, PricewaterhouseCoopers, 2002

The disadvantages include: (1) the lack of time to fully explore all the alternatives in a financial plan (people always feel rushed when paying by the hour), (2) you may be paying your advisor for what they don't know, and (3) there is no incentive for your advisor to provide superior service since hourly clients don't tend to be repeat clients.

Be sure to ask at what increments of an hour your advisor bills and if the rate is lower for the time that a junior or assistant is working on your file.

## SOME FINAL QUESTIONS & ANSWERS

***Q****: Why do I have to pay an initial retainer or the fee in advance?*

1. It is standard industry practice.

2. Most financial advisors don't have an accounts receivable department, so this just helps reduce administration costs.

3. Financial planning is a process. Paying in advance says you are committed and cuts down on procrastination because you want to get your money’s worth.

***Q:*** *Does my financial advisor have any limitations I should know?*

1. Your financial planner/advisor may be limited based on a lack of expertise in certain areas of your finances or, more commonly, on the type of products they recommend due to the type and number of licences they hold.

2. Their broker/dealer who supervises their compliance activity may also impose restrictions on the type of advice or services offered and the type of fees they can charge.

***Q:*** *Are the fees tax deductible?*

There is a misconception that all fees charged by a financial advisor are tax deductible. So you will have to ask your advisor what portion of the fees, if any, are deductible and how to can make the claim on your tax returns.

1. Investment Management or Counselling fees are deductible for the percentage of investment assets that are in a non-

registered account, but not for registered accounts such as an RRSP.

2. Accounting functions having to do with tabulating income (interest, dividends, and rents) are deductible as an accounting fee. Simply taking numbers from a T3/5 and putting them into tax preparation software would not qualify.

3. Professional fees are deductible for the self-employed and owners of rental properties if the fees are paid for advice relating to their business (again related to earning income). Since the financial plan for business owners and rental property owners often centers on these issues, this will give you greater latitude to deduct a larger share of the fees.

***Don't forget!***
***No work should be undertaken or fees levied without your expressed approval.***

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He specializes in comprehensive financial planning, investment counselling, tax planning and has delivered numerous seminars and workshops across Canada and abroad. His background in the financial professions provides him with a unique understanding of the complexity of comprehensive wealth management.

Marc has a history of staying in the forefront of the financial planning industry trends, transitioning to fee-for-advice in 1996. In addition, Marc is past-President of the Ottawa chapter of the Canadian Association of Financial Planners (now called Advocis), a faculty member of the Canadian Academy of Senior Advisors, a CFP™ Brand Ambassador, and a published author.

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