

# Fee-only versus Commissions & Fee-based

## Demystifying the difference

By: Troy Sapp, CFP®  
Commencement Financial Planning LLC

Examining how a financial advisor is paid is critical in understanding incentives and potential conflicts-of-interest they may have with your own. In this paper I will provide an overview of the three different structures under which all advisors may be paid and how advisor incentives may or may not create conflicts-of-interest.

### **Fee-Only**

Fee-only advisors only are paid based on a percentage of their clients' assets and/or on an hourly basis. Fee-only advisors receive no other compensation from any other source. This allows these advisors to review each alternative solution, and then provide their clients with an unbiased opinion as to the pros and cons of each.

Clients of a fee-only advisor can rest assured there are no conflicts-of-interest, but may feel discomfort clearly seeing what the advisor is getting paid. This is in stark contrast to commission and fee-based arrangements where the advisor is most often paid more handsomely, but due to opaqueness in the arrangements, clients are most often unaware of what is actually going on.

Fee-only advisors are by far the rarest of all financial advisors.

### **Commission**

Many advisors work solely on commissions. These advisors are not paid directly by the client. Instead, part of the purchase price of an investment is re-routed back to the advisor and the firm he represents. Many of these investment products such as annuities and insurance products also continue to pay the advisor and firm an income stream as long as the client continues to own and contribute to the investment.

The commission structure can easily provide the advisor an incentive to recommend products that are not in the client's best interest. Commissions may also encourage the advisor to recommend clients buy and sell products even if simply holding them makes the most sense.

Working solely on a commission basis is most common with sales of annuities, insurance, structured products, and with firms such as Edward Jones and Ameriprise.

### **Fee-based**

"Fee-based" is the most misunderstood term of all. Fee-based means the advisor receives fees based on both a percentage of assets *and* commissions. The largest of the fee-based advisors also have investment banking and analyst functions which potentially create the most insidious relationships of all.

The largest fee-based advisors receive recommendations from other divisions of their organization. These divisions often are in charge of running the "house's" investment portfolio and underwriting new issues of stocks and bonds. Further, since these firms

also have analysts covering the same stocks and bonds which they are underwriting, the analysts are under extreme pressure to provide positive reviews. The advisor, usually unwittingly, will call his clients with recommendations to purchase particular securities which other divisions in his firm are pushing. In the meantime, these divisions sometimes also hedge against these positions, meaning they are "taking the other side of the bet" of the very securities they are recommending the advisors sell.

The fee-based advisor is also often paid an incentive to encourage clients buy and sell securities more than is in the client's best interest. They simply are not paid if the client sits still. Many clients like this approach, though. The constant buying and selling makes them feel like they are in control, but in the long run the only one benefiting from the high level of transactions is the broker.

Incentives to increase client transactions are particularly disturbing. An advisor will be paid a set percentage of sales until he reaches a fairly high threshold. Once this threshold is met, the percentage payout retroactively increases. This keeps the advisor's eye on the larger sales amount.

These firms also have "pet" products which pay even higher commissions. These are usually new products with which the advisor creates excitement. The prudent client, however, does not leap into a new product, but waits until he has a full understanding of how it works and how it compliments his strategy. The latest example of this was Auction Rate Securities. Many fee-based clients jumped into these, but then lost enormous sums when it was discovered there was not an adequate marketplace or testing of such vehicles.

Most advisors are fee-based, the most prominent of which are Merrill Lynch, UBS AG, and Morgan Stanley.

### **Due diligence & performance measurement**

Advisor fees can be very difficult to understand and quantify. For fee-based advisors, fees are estimated to be in the 2-5% range annually. These high levels of fees are extremely difficult to overcome through performance. This brings us to the importance of due diligence and performance measurement.

Before you hire an advisor it's important to learn how they are paid as well as to get an estimate of how much their services will *actually* cost you each year. Once you decide upon an investment advisor it will then be critical for you to weigh their performance against appropriate benchmarks. Simply *thinking* their performance is good is not the same as *knowing* it is good. Measuring performance is not easy, though. Advisors know this and will often provide their clients with incomplete data or use benchmarks that are not appropriate. In fact, I have yet to see one commission or fee-based advisor provide good data without extreme pressure.

If performance is subpar, you should review your strategy and options. You should also consider other services the advisor provides to you outside investment advice since part of what you are paying may actually cover those services as well.

At the end of the day *caveat emptor* once again rules. BUYERS BEWARE!!