Why AUM Fees Still Make (Im)Perfect Sense

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By Bob Clark Editor-at-Large Investment Advisor Magazine

Back in the mid-1980s, a prominent financial planner (whose name escapes me) used to call it "the dirty little secret of financial planning." He was referring to the fact that financial planners almost never got paid for doing financial planning—an observation that is still true today.

The first "financial planners" were commission-paid mutual fund salesmen (there weren't any no-load funds back then). Then, when the stock market tanked and tax rates skyrocketed in the late 1970s, financial planners sold tax shelters. When the tax laws changed in the mid '80s, most planners switched to selling annuities, which remained the product du jour until the stock market rally turned into a bona fide bull market and managing mutual funds in allocated portfolios for a fee finally took the "sales" out of financial planning (not that there's anything wrong with that).

Or so I thought. Until I had a conversation the other day with a prominent financial planner who, shall we say, is not a fan of AUM fees. "Just another form of commissions," she called them, citing the conflicts that arise when a client might benefit from taking part of their investment portfolio and paying off their mortgage, and that holding some assets, such as bonds to maturity, certainly doesn't warrant a "management" fee. She went on to suggest that instead of the current, flawed fee compensation model, leading financial planners today are shifting to the far more client-centered flat annual fees for financial planning.

Even though she was advocating an expanded version of financial planning—that goes even beyond George Kinder's Life Planning—to include applying the latest research on behavioral economics and client communications, I have to admit that I did not react well to her "attack" on AUM fees.

Being ancient enough to have experienced those days when many financial planners were salespeople (again, not that there's anything wrong with that), I have a reverence for the transformation of retail financial advice prompted by AUM fees. In my view, AUM fees have taken independent advice to the next level, in four important ways:

1) AUM Fees Solidify a Fiduciary Standard for Retail Advice-Givers

There is no substitute for a legal duty to put the clients' interests first. Even though many advisors, particularly some brokers and CFPs, consider themselves only part-time fiduciaries for each client, it's had a dramatic effect on all financial advice, as more and more clients are asking why they aren't their fiduciaries all the time. Even SIFMA is slowing acquiescing to a full-time standard.

2) AUM Fees Put Advisors (Mostly) on the Client's Side of the Table

Yes, AUM fees still have some conflicts, most notably the two mentioned above, and the advisor's fee itself. Of course, this conflict exists with every transaction where one person pays another person for a service. With access to information, such as the Internet, people can check the going rates and make good decisions. We already see this happening. More importantly, advisors get paid more only when client's portfolio grow. Is that perfect? No. But it's waaaay better than the old days. I've been there.

3) **AUM Fees Create Recurring Revenue**

   Ongoing fees revolutionized the business model of financial advice. Rather than starting each year with zero revenue, and having to "sell" something to each client again or find new clients, fees allow revenues to compound, and to grow as client portfolios grow. What more, recurring fees have a marketable value: within the past 20 years, a market has emerged to buy and sell advisory firms, in many cases for millions of dollars.

4) **AUM Fees Enable Independence**

   To my mind, this is the most important benefit of fees: for both advisors and their clients. AUM fees paid directly by the clients mean that their advisors are not financially beholden to any other firm. Even custodians are replaceable, as we've seen in the trend for advisors working with multiple custodians to get the right service/product/cost level for each client. Even advisors who still work through a broker-dealer enjoy a much higher degree of independence (and payouts) than ever, as their BDs are well aware of the ease with which they could move to a custodian. While independent advisors aren't conflict free, they have far fewer conflicts than their wire house counterparts.

Taken together, these effects of charging AUM fees have made independent advice today's "go to" business model. It's why many brokers are leaving wirehouses, and why a fiduciary standard for brokers is under discussion. In fairness, these advantages would apply to flat financial planning fees, too, with the exception of sharing in the clients' financial success, and growing revenues when the market goes up. (Of course, they avoid losing revenues when the market goes down.)

The biggest problem with flat financial planning fees is that many planners have tried them over the past 40 years with very limited success. Occasionally, we've seen some advisors who've made them work, most notably those in the Garrett Planning Network, who charge their clients by the hour. The problem is that there's a limit to how much they charge per hour and how many hours a week they can work: plug in your own figures and do the math—it's not pretty.

Would it be better if financial planners charged their clients a flat fee every quarter? From a conflict standpoint: probably. And it would be nice if financial planners finally got paid to do financial planning. Is it a viable business model on a large scale: Probably not. Historically, clients have had a hard time paying for financial planning just once. Asking them to pay for it year after year, when their financial plan remains essentially the same, has always been a very hard sell.

Growing client assets is the engine that drives any financial plan. That's why it makes more sense to clients—and for advisors—to charge for growing those assets, and to provide financial planning to use those gains to reach their clients' life goals.

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No, Asset-Based Fees Don't Make Any Sense

In his most recent blog for ThinkAdvisor, "Why AUM Fees Still Make (Im)Perfect Sense," Bob Clark makes multiple arguments for why charging a fee for assets under management is optimal for advisors and their clients. James Osborne, a CFP and founder of Bason Asset Management in Lakewood, Colo., responded with a blog on his own site. With his permission, we've edited Mr. Osborne's blog (slightly) and present it below.

Bob Clark makes a great point that I have also made: AUM (assets under management) fees are measurably better than commission-based pay for financial professionals. AUM fees have moved us away from product sales and towards independent investment advice.

But "better than commissions" isn't a defense of the AUM model. And Bob lays out four points why he feels AUM fees are appropriate, which I will address in turn.

1) **AUM fees can create a fiduciary standard**

   I suppose this is true if we are comparing AUM fees to commissions, but in no way do AUM fees allow for a fiduciary standard *more* than a flat retainer fee or hourly charges. In truth, the Registered Investment Advisor model and the Certified Financial Planner board have led to the increase in public awareness of fiduciary advice, but neither dictates the use of asset-based fees.

2) **AUM fees put advisors on "the same side of the table"**

   I've addressed this argument before and generally I think it is nonsense. The line of "advisors get paid more only when client's portfolio grow (sic)" is a half-truth at best. Advisors get paid more when they gather more assets, either from new clients, or, ideally for the advisor, gathering more assets from the same client. This way the advisor makes more money for doing the same work. You also can't effectively incentivize a person to do the impossible. I could offer my border collie a handful of bacon to mow the lawn for me, but I'll still be pushing the lawnmower. Advisors do not have direct control over the growth of an investment portfolio – markets, not managers, generate investment returns.

3) **AUM fees create recurring revenue**

   While I'm not sure how this is measurably a good thing for clients, the same could be said about annual (or monthly) retainer fee structures, as well as hourly fees for annual financial "check-ups." Accountants, attorneys, doctors and dentists don't need to sell new products every year to drive revenue—they provide a service that clients value and pay for.

4) **AUM fees enable independence**

   The shift away from commissions has been good for consumers as it creates a less-biased environment for advisors to work in. But as AUM fees may allow for independence, it is only more true that retainer fees and hourly fees provide even greater independence, as they eliminate the asset-gathering/asset-retention conflict.

Lastly, I always find myself scratching my head when people in the industry claim that a retainer fee structure isn't a viable business model. For one thing, it works for practically every other profession. Why should our fees be based on a client's ability to pay rather than actually paying for the services they receive?

I'd also suggest these people get in touch with me, Carolyn McClanahan, Steve Evanson, John Gorlow, Sandi Martin, Jason Hull and others who are living proof that a retainer or hourly fee model works well for financial professionals and their clients.

The Pros and Cons of AUM or Flat Fee Compensation for Advisors: Part 2

By Bob Clark
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Apparently, I stuck a nerve among flat-fee charging advisors with my March 26 blog for ThinkAdvisor, "Why AUM Fees Still Make (Im)Perfect Sense." The responses included a Twitter conversation started by financial planner Carolyn McClanahan, and a ThinkAdvisor guest blog by James Osborne of Bason Asset Management, titled "No, Asset-Based Fees Don't Make Any Sense."
First, let me say that I have the greatest respect for flat fee-ers: The folks in the Garrett Planning Network and others who have made the choice to earn less money and create less value in their practices in order to follow their consciences and serve the middle market and/or reduce conflicts with their clients. My hat's off to them.

In fact, the flat-fee folks embody the reason I started writing about and for independent advisors 30 years ago: back then virtually all of them could have made more money as brokers or insurance agents but chose to go independent to better serve their clients. I've always had great respect for that approach—and still do: Today's independent advisors who charge AUM fees invariably charge a fraction of the 160bps to 250 bps that many breakaway brokers seem to feel is appropriate. With that said, I have a hard time getting behind the current "flat-fees for everyone" movement for two reasons:

1) rather than a "new" idea, it's an old idea with a history of very limited appeal, for good reasons; and

2) the current tactic by flat-fee advocates to vilify AUM fees.

Here are two examples of the current trend to denigrate fees on AUM. Last week, I wrote about an advisor I talked with who referred to AUM fees as "commissions." As if. And the above referenced title of Mr. Osborne's blog: "No, Asset-Based Fees Make No Sense." No sense? Really? I respectfully suggest that this kind of over-the-top hyperbole (is that redundant?) only serves to make the flat fee-ers look like true believers, while doing nothing to further a reasonable discussion of the relative merits of these two methods of advisor compensation.

As I acknowledged in my earlier blog, Osborne and others are right to say that flat fees offer many of the same advantages as AUM fees: a fiduciary duty, economic independence and recurring revenue. But as far as putting the advisor on the client's side of the table, I'm not so sure. For one thing, flat-fee advisors make the same money whether their clients' portfolios go up—or down. AUM fees, obviously, reward advisors when client portfolios go up, and penalize them when portfolios go down. That kind of identity of interest seems better.

At the same time, while flat fees "eliminate the asset-gathering/asset-retention conflict," as Mr. Osborne wrote, they also create conflicts of their own. Osborne went on to say: "I always find myself scratching my head when people in the industry claim that a retainer fee structure isn't a viable business model. For one thing, it works for practically every other profession – CPAs, attorneys and others have long worked under an hourly or retainer structure to great success."

Great success? Really? The average small accounting firm is worth about 1x annual revenues: the average AUM fee-only advisory firm is worth between 2x and 3x revenues—and those revenues per client are usually much higher. What's more, anyone who's ever worked with an attorney and/or accountant is well aware right from the start of the built-in conflict of interest: billable hours. The client has no way to know how long those professionals spend on their case, and the professionals have an incentive to take as long as possible. Why should one lawyer or CPA get paid more if they have to research a question than one who already knows the answer? Bad example, Mr. Osborne.

The most cogent comment in Carolyn McClanahan's Twitter discussion came from Bob Veres (Bob Veres @BobVeres Mar 28): "[Bob Clark's] column ignores the evolutionary nature of the profession. AUM is a waystation, nothing more." Bob is absolutely right: the present is prologue for the future. But I'm not sure he realizes the full implication of that thought. The other side to that coin is that no one knows how the present will evolve into the future: not me, not Bob, not the folks who advocate flat fees. Yet some want to use the concept of change to support their own predictions of the future when, in fact, they are just that: merely predictions, nothing more.
I have no doubt that the current business model(s) of independent advice will change. It is both my hope—and my prediction—that part of that change will include a move toward even greater independence: such as away from conflicting affiliations (including the custodial perks that Michael Kitces has written about), and away from technology platforms that limit access to investment choices. We see this happening already, as many independent advisors are working with multiple custodians to offer more choices and get better pricing for their clients.

Flat fees are more problematic. Are they really the "wave of the future" or a recycled idea from the past that didn't get widespread traction the first few times they were tried? To wit: financial planning fees in the '80s, the Garrett Planning Network, which to my knowledge has never attracted more than 300 or so advisors, and the advisors who shifted from AUM fees to flat fees in the wake of the Dot.com crash in 2001, only to shift back to AUM fees in time to take another hit in 2008.

Despite our current "youth-culture" mentality, the past does inform the present—and the future, as Harvard philosopher George Santayana reminded us when he said: "Those who cannot remember the past are condemned to repeat it."

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4 Uncommon Advisory Fee Structures

SEI Advisor Network surveyed financial advisors to determine how they're charging clients for their services

No fee structure is one size fits all.

There have been arguments in the industry about whether the assets under management-based fee model still serves investors — or whether some other model would be better.

According to a recent SEI Advisor Network study, nearly 90% of advisors are currently using an AUM-based fee model in some capacity. But no fee strategy is one size fits all. Certain client situations, like small accounts or advice on assets held away, may be more suited to other fee structures.

SEI’s Raef Lee, head of new services and strategic partnerships, and John Anderson, head of practice management services, discussed the results of a recent survey of 775 financial advisors that examines the advisory fee landscape, pricing trends and different strategies during a webinar on Monday.

Based on its survey results, SEI looked at a few fee structures for special situations, and Lee offered his take on whether the strategies were advisable.

1. Retainer Fee for Small Accounts

Of the 775 respondents to SEI's survey, 74% did not have a fee structure for smaller accounts.

As SEI sees it, most advisors who serve small accounts are driven by a desire to lure HENRYs (High Earning, Not Rich Yet), a Gen X/Y advisor business model, referrals, merged books of business or early clients.

SEI finds that the typical fee structure for smaller accounts is some sort of flat retainer, rather than the typical AUM fee model. For example, a flat retainer varying from $600 to $5,000 a year.

“If you are going to charge a different fee structure for these smaller accounts, it means that you really should be offering a different service for these accounts,” Lee said.

However to differentiate between services and fee structures would mean a lot of work for the advisor.

“That is a fair amount of work to set that up as a different approach and service model and maybe even different people doing it,” Lee said. “What we find is that advisors don’t necessarily want to do that, and also advisors, to be honest, aren’t disciplined enough to be able to pull that off.”

According to Lee, small accounts would be a “very good way” to test out a retainer model to see if that model works for clients and advisors.

2. Financial Planning Fee

SEI found that 26% of the advisors surveyed charge fees based on an AUM model plus some sort of fee for initial financial planning. Typical fees are between $1,500 and $10,000 depending on service and client complexity, according to SEI.

“The amount of work necessary to do that initial financial plan is a lot," Lee said. "Therefore, you’d think it’s a clear value and you should charge for it.”

However, he adds, that may not be clear to clients.

“If you have a brand new client, they really don’t know you and the first thing you’re doing is asking for quite a bit of money to perform a service,” Lee said. “So that’s a reason why some advisors decide not to do this.”

Lee also adds that financial planning is “fundamentally changing” from “the concept of an initial spike of work and then little work ongoing” to a co-planning model where advisors work with clients on an ongoing basis.

“It’s much easier in that model to show a value proposition, which means you should be getting paid for that financial planning advice on an ongoing basis,” Lee said. “In fact, we find that a whole series of advisors are using that approach and that explanation of a value proposition to justify the 100 basis-point AUM fee.”

3. Assets Under Advisement Fee

SEI examines whether advisors charge for assets under advisement, or “held away” assets, typically a 401(k), 403(b) or 529 plan.

Lee considers these assets as “something that you may not have directly under your management and you won’t be able to change and truly manage those assets, but you are giving the clients some sort of advice on what to do with them.”

According to its survey results, 45% of advisors say that they charge in some way for those assets. They charge, typically, around 50 basis points, or around half their normal fee.

“This is an area where there’s been a lot of change, in that you’ve got companies like Mint.com and other areas where the aggregation capability, which is what’s necessary to do this type of advice, is becoming almost free to investors,” Lee said. “The value for them to be able to look across and see all of their assets is not nearly as valuable as it used to be.”
Lee does point out one case where he sees this type of fee makes sense.

“If you are trying to coordinate multiple pools of money or multiple generations and your key value is to look across all of that information and give advice, then that makes more sense as to why you’re charging for that.”

4. Salary Plus Total Net Worth Fee Structure

A “brand new” fee model that SEI examines is a fee based on salary plus total net worth.

“We’ve seen at least two companies, maybe more, look at this,” Lee said. “This is a different model, which is the concept of doing a salary plus total net worth as the base of what you charge.”

For example, say a client has a net worth of $1.5 million, AUM of $1 million and a salary of $250,000. If an advisor charges 1% of net worth plus 0.5% of salary, advisor fees would equal $16,250. Whereas, under the AUM fee model, 1% of the AUM would be $10,000.

“Why is this interesting? It’s interesting because it really does align the client with the advisor because … clearly the client wants their net worth to grow,” Lee said.

What advisors should do: Because this fee model is so new, Lee is cautionary.

“There’s certainly some early adopters that are doing it, but if you were using this sort of model you’d really have to explain to the client out of scratch what this is about,” he said.