Why It Matters How Your Advisor Is Paid

By Eve Kaplan, CFP®   Kaplan Financial Advisors LLC   NAPFA Planning Perspectives 4/2012

Who gives you financial advice? Why does it matter how he or she is paid? Because it's probably the most important thing determining the quality of advice you receive. The SEC and other federal agencies have been studying the hotly contended "fiduciary responsibility" issue because billions of dollars are at stake, and most consumers and investors remain confused and underserved.

Can you answer these questions?

• What are the differences between brokers, insurance agents selling investment products, and "financial advisors" (some regulated, some not)?

• What's the difference between "Fee-Only" and "Fee-Based"? (Hint: They sound alike but they're quite different.)

Here's a brief guide to help untangle these concepts. Brokers and insurance agents: Brokers and insurance agents can and do sell financial products (A, B, and C mutual funds, annuities, variable life insurance, annuities). Their standard of fiduciary care is a "suitability" standard. This standard of care means they are legally allowed to benefit more from product sales than their client benefits—as long as their products are very broadly considered to be "suitable" for that client. Not optimal, just suitable. Advisors and financial planners: This term is confusingly broad—some advisors have no designation, but others can have earned designations such as CFA, CFP®, ChFC®, or CPA/PFS. These are dozens of designations in financial services, but those four are widely acknowledged to require a substantial amount of study in order to pass exams and an adherence to standards of oversight.

For the purposes of this discussion about compensation, I'll focus on financial advisors who interact with the general public and who either: a) sell products, or b) don't sell products. Advisors who sell products can hold any of the above-mentioned designations. Many of these advisors operate with "fee-based" compensation, which means that advisors can earn compensation from fees paid directly by clients PLUS fees they receive in the form of commissions or discounts from products they're licensed to sell. They are not required to inform their clients in detail how their compensation is accrued.

The fee-based model creates many potential conflicts of interest, because the advisor's income is affected by the financial products that the client selects.

Fee-Only advisors, by contrast, do not sell any financial products. If their clients need products (e.g., insurance), they work with professionals they trust, but the advisor does not receive a split of the fee with the insurance agent. There is no inducement to the advisor for the sale of products. Fee-Only advisors typically charge a percentage of investments they manage or charge by the hour or through a retainer arrangement. Conflicts of interest are kept to a minimum with this kind of fee structure.

The Critical Issue of Fiduciary Standards

An advisor held to a fiduciary standard occupies a position of special trust and confidence when working with clients because he or she is required to act with undivided loyalty to the client. This includes disclosure of how the financial advisor is to be compensated and any corresponding conflicts of interest.

If your advisor does sell products, it's hard to know if your needs are deemed more important than his or her desire to earn a commission. Is it really better for you to buy a mutual fund with a 5.75 percent front-end load (commission) from your broker than to buy a mutual fund with no up-front commission? Are you getting sufficient services from this broker to compensate for those fees? (Are you even aware of the fees, which have been automatically deducted at the point of sale?) Is it really better for you to tie up your money in an annuity that charges 3 percent or 4 percent per year, instead of putting your money into mutual funds that cost one-tenth of that amount?

Time and again, studies show that clients can be poorly served when product sales commingle with investment management and/or financial planning.

A better way to receive investment advice, management, and financial planning is to work with professionals who are required to put your needs before their needs. These individuals adhere to the highest standard of fiduciary conduct and do not combine product sales with giving advice.

NAPFA Headquarters
3250 N. Arlington Heights Road Suite 109 Arlington Hgts, IL
847.483.5400
847.483.5415 Fax