My Word By Bert Whitehead

AUM Under Fire

The adviser's quandary: How to construct an ethical fee arrangement.

UNTIL RECENTLY, CHARGING clients a percentage of assets under management (AUM) was considered a legitimate fee-only option. It eliminates the conflict of interest inherent in commissions, which can tempt advisers to churn clients' accounts. But today this approach is having its moment of scrutiny. AUM's conflicts of interest are subtler, but real.

THE TOP 10 PROBLEMS WITH AUM

1. The adviser recommends the asset allocation for a client's portfolio, following the standard practice of charging a higher rate for stocks (1.5% of assets) than for bonds (0.5%). This creates a strong bias to overweight equities.

2. The adviser's suggestions about whether to buy or sell real estate and how much to mortgage are tainted by self-interest. It is to the adviser's advantage to keep assets in portfolios, not in dwellings.

3. The client's decision to gift to children or contribute to charities affects the amount of assets under management.

4. People do what they're paid to do. To the extent they're paid to manage assets, they concentrate there. As a result, they skimp on comprehensive planning.

5. When the adviser discloses potential conflicts in the AUM model to the client, the adviser diminishes his credibility.

6. During the bear market, many firms faced fixed operating costs while repositioning assets in fixed income, thereby reducing their cut. About 30% of AUM firms went under at the time, in part because they did the right thing for clients.

7. AUM advisers are not compensated for other, related financial advice.

8. Clients are averse to disclosing all of their assets to avoid pressure to consolidate accounts.

9. AUM often doesn't offer full disclosure to clients (e.g., an adviser's quarterly statement doesn't clearly note the fee).

10. The SEC's revision of the "Merrill Lynch rule" precludes salespeople licensed with broker-dealers from calling themselves financial planners or offering planning. To the extent financial planners use the same AUM compensation as brokers, the distinction is lost on the public.

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BETTER WAYS TO BILL

Finding suitable alternatives to AUM is challenging. Other approaches may present drawbacks and conflicts, too.

Hourly Billing: Often used to serve middle-income households whose investments can't generate enough revenue to make the AUM model worthwhile. Drawbacks include client resistance to running up a tab, especially for research time when the client isn't present. Hourly fees may be seen as rewarding advisers for being stupid and plodding: The slower they work, the more hours they can bill.

Percentage of Net Marketable Assets: Asset-allocation issues, real-estate transactions, leveraging and mortgages become nonissues when the fee is based on the client's net marketable assets, which include stocks, bonds, cash and real estate. The main drawback: many advisers aren't sufficiently trained to advise clients on real estate and mortgages, particularly because of their tax implications.

Flat Retainer Fees: The preferred approach of many experienced advisers is charging a retainer, either on a project basis or through an annual renewal program. Short-term project retainers typically range from $400 to $1,000 for two to four hours of consultation and little or no follow-up. Annual renewable retainers, based on the complexity of the client's personal situation as well as income and assets, let advisers enjoy a regular income stream from repeat clients. This reduces potential conflicts of interest and generally produces the highest percentage of new client referrals.

The largest potential drawback is that the adviser may not provide the level of service expected by the client. And advisers may undercharge because they can't predict how much work a client will require. Still, experienced planners say the system works well.

Planners must be aware of the substantial conflicts of interest involved when AUM determines clients' fees and consider the ethics of alternative approaches. The SEC's adoption of the Merrill Lynch rule makes this all the more important. Although annual-renewal retainer fees are the least likely to raise conflicts, less experienced advisers may be wary of setting a fixed fee. They need to gain confidence that they offer sufficient value and will be adequately compensated. FP

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