How Financial Advisors Get Paid and Why it Matters to You

January 2012

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January 3, 2012

Introduction

Someone giving personal financial advice may use a variety of titles: financial adviser, financial consultant, financial planner, financial analyst, investment consultant or wealth manager. These are generic terms or job titles and may be used by investment professionals who may not hold any specific designation. For purposes of this discussion, I'm going to use the term "financial advisor" and anyone who calls her/himself a financial advisor gets paid in one of four ways:

1. **Commission only**. An advisor who is paid this way receives commissions for selling financial services products like insurance, investments, real estate, municipal bonds or home loans. Advisors who work for State Farm, Allstate, and Century 21 are paid this way.

2. **Commission and fees**. This is the way most financial advisors are paid. You may hear the confusing term "fee-based" applied to this income method. An advisor that is paid through commission and fees receives commission for products they sell you and may also receive fees for certain services. For example, a commission and fees advisor may receive a fee for developing a financial plan then be paid commissions for the products she/he uses to implement the plan. Representatives from Edward Jones, Ameriprise, UBS, Merrill Lynch and other brokerage houses are paid a combination of commissions and fees.

3. **Salary and bonus**. Representatives of discount brokerage firms like Schwab, TD Ameritrade, Vanguard and Fidelity are paid by salary and bonus. They receive a base salary for their day-to-day work and incentives for bringing in new clients and for recommending certain products and services over other options. For example, Charles Schwab and Company purchased a specialized investment management company in late 2010. A client of mine was recently approach by his Schwab representative to see if he wanted to direct some of his money to this investment management company. The Schwab representative assured my client that he is not paid by commissions, but it is very possible he is paid a bonus for directing clients into this investment management company.

4. **Fee-only**. These are advisors who are <u>**only**</u> paid fees from their clients for the services they provide for them. The services a fee-only planner provides may be broad (developing a comprehensive financial plan that looks at all aspects of your financial life) or narrow (on-going investment management services). A fee-only planner isn't a registered representative of any financial service company. She or he is typically self-employed and either owns a Registered Investment Advisor (RIA) company or works for one.

Fee-only planners charge in one of these ways (or a combination of these methods):

Hourly: the client pays for all the time the advisor works on the client's case. Like the hourly rates for attorneys, fee-only planners have a large range of costs. Depending on where the advisor is located, hourly fees range from $150 to $300 an hour.

Flat fee or project fee: for a specific project with a defined beginning, middle and end, some advisors charge a flat fee. For example, if a client wants a retirement income analysis, investment review or college funding analysis, an advisor may quote a flat or project fee.

Retainer fee. A retainer fee is often used for advisors who offer on-going services to clients. For example, on-going investment management advice is often on a retainer fee arrangement. A retainer fee may be a percentage of assets under management (called AUM by the industry) or a dollar amount (flat fee).

Why does it matter how a financial advisor gets paid?

There are competent professionals who are paid using each of these four methods. For example, someone who sells homes or auto insurance is typically paid a commission on the home you buy or the insurance you buy from him or her. Similarly, a stock broker is paid a commission for efficiently and effectively executing a mutual fund buy or sell order.

So why does it matter how a financial advisor gets paid?

1. Like any product or service, some advisors charge more and others less. All things being equal, we all want to pay the least amount for a service so more of our money can work for us. The way an advisor gets paid affects how easy or hard it is to determine the total cost for a service. If you work with a fee-only planner, you'll know the total cost of his/her service. You will not know the total cost of working with an advisor who is paid any other way. You may ask what a Merrill Lynch or Edward Jones broker gets paid to work with you, but he/she doesn't have to tell you and you may never know.

2. You need to trust the advice you are being given and it is difficult to trust the service provider if he or she is not open about the total cost of their services. The internal dialogue goes something like this: "If Bob won't tell me what he's making on my money, what else isn't he telling me? How can I trust him?" In addition, did you know that some advisors are *legally obligated to provide advice that is only in your best interest and others are not?* Advisors who accept the legal obligation of working only in the client's best interest are called a "fiduciary." (See the section below on *"What Is a Fiduciary?"* for more on this). The way an advisor gets paid dictates whether or not the advisor is a fiduciary.

3. The way an advisor charges may restrict the options for implementing your financial plan that the advisor suggests to you. For example, if an advisor is paid a commission for an insurance product, then he or she is unlikely to suggest any other choices for you. After all, the insurance company that employs the advisor wants to sell their products. Think of the issue of long-term care. There are at least four ways to pay for the cost of long-term care and insurance is only one of them. Someone who sells long-term care insurance will likely only offer that solution. This is

sometimes called the Maslow rule: if the only tool you have is a hammer, everything looks like a nail. Finally, a commission only broker is unlikely to recommend a no-load mutual fund because he or she doesn't get paid unless you buy one of their mutual funds with a commission attached to it.

4. In order to reach your goals, you need to make good decisions about your assets. The way an advisor gets paid may influence his or her advice to you. A financial advisor wants to be paid for his or her services and expertise just like any other knowledge expert. In general, an advisor wants to get paid more rather than less. Some models of how advisors get paid profit him or her more than others. A representative of a discount broker like Charles Schwab, TD Ameritrade or Fidelity has incentives to recommend or sell certain products and not others. Similarly, a Merrill Lynch or UBS broker gets paid fees by some mutual fund companies for selling their products over others. Given this conflict of interest between your best interests and a commission and fees advisor, it may be unclear if the advice is best for you or your advisor?

What is a Fiduciary?

It may seem like anyone who gives advice to you about your finances should be legally required to act in your best interest, but they are not. Dating back to the 1940's, there have been two sets of standards for those who give financial advice.

A "fiduciary" is bound by law to place the interests of the client first. On the other hand, a non-fiduciary financial advisor follows something called the "suitability" standard. Under this standard, a financial advisor must only provide "suitable advice" to her or his clients **– <u>even if the advisor knows that the advice is not the best advice.</u>** If a non-fiduciary wanted to follow the fiduciary trust standard, she/he could not because of the contract the advisor has with his or her employer. Employers require that the financial advisor *place the company's interests first, before the interests of the advisor's clients.*

Put another way, a non-fiduciary advisor owes the fiduciary duties to her or his employer and not you. A fiduciary owes his or her fiduciary duty only to you, his or her client.

Summary – Which Advisor Type is Best for You?

Here is where we get very subjective. The short answer is that the best advisor for you is the one that best meets your needs. So to answer the question, you have to know what you need. For example, if all you need is life insurance, then an advisor who sells life insurance may be fine. The same is true if you need auto and home insurance, a mortgage, a municipal bond or an annuity. However, when your needs get a little more complicated, the answer gets more difficult.

If you want someone to make investment decisions for you, then a commission and fee advisor like an Edward Jones broker may be fine. Just realize that you will probably never know the total cost for your investments. If you just want someone to execute your investment buy and sell orders, then a representative from Schwab, TD Ameritrade or Fidelity who is paid by a salary plus bonus system may be fine.

The danger is that advisors who are compensated by commissions, commissions and fees and salary plus bonus will always try to expand their services to include things that they are not well suited to do and may not be in your best interest either. For example, an insurance person may try to sell you investments that his company offers, a commission and fees advisor may try to sell you annuities in your IRA and a salary plus bonus representative from a discount brokerage firm may push products on you for which they are paid a bonus.

A fee-only financial advisor is the best choice for most people, but not everyone. When you work with a fee-only financial advisor, he or she cannot sell you products like insurance so you will have to deal with a second financial product provider. In addition, you may need to do more yourself with a fee-only advisor. For example, a fee-only advisor that is paid a percentage of assets under their management may not want to help you with your 401(k) allocation.

Still, there are considerable benefits to working with a fee-only financial advisor:

1. You don't have to worry that a fee-only advisor will make recommendations that benefit him or her and not you. If the fee-only advisor is also a fiduciary, he or she is legally required to act in your best interests so that is an extra layer of assurance that the advisor is on your side.

2. You know how much it will cost you so you can assess the value you're getting for the fees you pay.

3. You will also likely build up a higher level of trust with a fee-only advisor because his or her fees are transparent. It's easier to trust someone who is giving you advice when you know what it costs.

4. The advisor will not be trying to sell you products (simple or complex). A fee-only advisor only gets paid for his or her advice so products will never be part of his or her package. A fee-only advisor has no incentive to sell you anything. The focus on your conversations will be solely on what's best for you.

    - This allows you to both explore a wider variety of options to meet your goals, and
    - Offers you a greater list of products and services from which to choose.

5. You will have more control over the start and stop of the relationship because there are no strings attached to a working relationship with a fee-only advisor. If you don't like what the advisor is doing, saying or not doing or saying, then quit and go find another fee-only advisor. This creates an incentive for the fee-only advisor to focus on meeting your needs.

About the Authors

Steve Juetten, CFP® is a fee-only financial advisor and has only ever been a fee-only advisor since he began serving individual clients over ten years ago. And clients must like what he does because he's been named a 2010 & 2011 Five Star Wealth Manager by ***Seattle Magazine***. Steve is often quoted in *Forbes.com, Bankrate.com* and *MSN Money.com* on a variety of personal financial planning topics.

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Before joining Juetten Personal Financial Planning as an Investment Advisor Representative in 2011, **Dan Maul** was a nationally recognized expert on retirement plans for companies and small business owners. His expertise was the subject of features in the *Wall Street Journal, Forbes, Money Magazine, Inc., CFO, Nation's Business, Kiplinger's Personal Finance Magazine, U. S. News & World Report, MSN.com* and on the *Business Radio Network.*

In addition to fly fishing and gardening, Dan is an active volunteer and was recently named Volunteer of the Year by Olive Crest, a not-for-profit that provides services and families for abused children.