Fees or Commissions: Which Are More Profitable?

Originally Published by InvestmentNews

The following is an edited transcript of a webcast, "Boosting your bottom line: Balancing fees and commissions for optimal revenue generation," held July 16. Moderators were InvestmentNews *deputy editor Greg Crawford, and director of digital and data strategy Mark Bruno.*

InvestmentNews: We're going to talk today about several areas around the issues of fees versus commissions and how to drive profitability, the best mix, the best business model or business models, and how they look.

Our experts include Sheryl Garrett, founder of the Garrett Planning Network. She works with clients on an hourly, as-needed, fee-only basis, and that has evolved into a nationwide network of like-minded financial advisers.

We are also joined by Dan Seivert, chief executive and managing partner of Echelon Partners, one of the leading investment banks and consulting firms to the wealth and investment management industries.

And finally, we have Ken Evans, director of operations at Moss Adams Wealth Advisors. He has spent several years as a management consultant with Moss Adams LLP, focusing on business management and transition issues faced by financial advisory firms, investment managers, broker-dealers, banks and certified public accountant firms.

WHAT FEES DO FOR REVENUE

This is a question that comes up quite a bit, particularly around the time of year where we put out our financial performance and staffing-and-compensation research studies, which we have worked on in tandem with Moss Adams. One of the things that came out of the financial performance study that we did last year was an analysis of the fees that advisers are charging and what they are doing with their fee structures to drive revenue.

About 20% of the firms that participated in our study last year changed their fee structure. That seems to be pretty consistent year-over-year. Unsurprisingly, 87% raised their fees, and in a lot of cases, they are doing that to address situations with clients that aren't necessarily profitable. Do they have a client that they are spending too much time on — and not generating enough revenue off of — and is there a quick and easy way to fix that issue? That is just one scenario.

The question is, what is included in this fee? Everybody has a different model; everybody has a different mix of services that they could potentially offer. You have a lot of different options as an adviser who charges fees and who also is potentially looking at a mix of commission-based business. Looking at what is your base fee and what are the services that you provide as part of those fees would be the first place to start.

I wanted to start with this question of an assets-under-management scale and how to build for financial planning. Ken, how can folks understand the AUM breakdown and then plug that into their own business model?

Mr. Evans: There are a couple of ways to look at it. Obviously, when you're looking at an asset-based fee, there is the internal perspective about how much it is going to cost you to deliver services. Clients of varying sizes have typically varying levels of profitability. When we're looking at those AUM-based tiers, it is an attempt to model the economics of the firm after the pricing schedule that is being put in place. Another perspective that's often very good to incorporate is the external-market perspective, and there are a couple of ways to go about that. Participating in research studies like the *InvestmentNews*/ Moss Adams study is a good way to get a general sense of the business models and the typical types of fees that are charged by firms in those various models, and by size and other segmentations. The other way is to do primary research, as well. Form ADV Part 2s are fully searchable with the SEC now and there are a lot of proposals floating around the industry. All of those are important when we're trying to understand what is an asset-based fee, what is included and why is it at the level it's at.

InvestmentNews: Dan, you have done some work kind of around this relationship between the fee model and the business model. Can you share your perspective on that?

Mr. Seivert: Given that we're involved in valuing firms and helping firms maximize their value, we come across a host of different business models. Some firms are just focused on providing wealth management or wealth advisory services, which are asset allocation and manager selection. Other firms are also involved in investment management and then it goes beyond that, as well; some firms are doing trusts and estates, some are doing financial planning, some are involved in private-banking business [or] accounting. A big question that comes up is the difference between fees and commissions. We ask a more detailed question, which is: Is the revenue stream recurring? That tends to be the most important element. You can look at hourly or flat fees, and if you can demonstrate that they're recurring, then you're going to get the benefit of that being higher in valuation. One key example is, you might have a commission-based business, but if the nature of it recurs every year — where you get a standard set of transactions associated with a certain client and it lasts throughout the business cycle — then oftentimes you can get the recurring-fee value for the commission business. So it's more intricate and not as simple as some of the axioms that you read about.

InvestmentNews: Sheryl, regarding the question of how you can make your business model run at optimal profitability, you often talk about not necessarily using the word "profitability," but using other metrics such as success and satisfaction. How do you balance that? Because folks obviously have to put food on the table and pay for college and retirement.

Ms. Garrett: I think it's very critical. When we're talking about compensation structures, and business models or service models, it frequently boils down to: What type of offering do you want to be involved with? What types of clients do you want to serve? How do you want to spend your day? And do you get joy or personal satisfaction out of the work that provides a great deal of your quote-unquote "compensation." We need a certain amount of revenue to enjoy what we do. To be able to fund our own retirement, to pay for the kids' college, a certain amount of income, or revenue or net revenue, is critical. But at the same time, nearly every adviser I've spoken with says that the quality of life and the people whom they serve — and the way they serve them — is a huge component in measuring success or their happiness as an adviser. So profitability is important, but I think it's one aspect of whether one would choose a service model or a business model. It also needs to provide that personal level of satisfaction or success that would cause us to get up every day and want to go in and really get joy out of the type of work that we do. I've had other roles in this industry and made more money doing things different ways, but I wasn't as happy, and therefore I would have to say I wasn't as successful. It's not all about the almighty dollar. It all boils down to how we want to utilize our time, talents and energies on the betterment of our clients and whom do we want to work with and how best we can meet their needs.

WHERE'S THE BALANCE?

InvestmentNews: Ken, what are your thoughts on the work-life balance?

Mr. Evans: I think it's an important issue to bring up. In many cases we're looking at satisfaction not just from a profitability or from a revenue standpoint but from that work-life-balance standpoint. That was actually one of the criticisms that we've received a lot over the years, either as management consultants or as former authors of the*InvestmentNews*/Moss Adams Study, that we focused too much on profitability as the "be all, end all" measure of success for an advisory firm. The counterargument to that is that a lot of business practices — whether it's balancing fees and commissions or aligning your service model with your fees — ultimately can lead to additional satisfaction or additional work-life balance in the business, just as they could lead to additional profitability. Whether your ultimate goal is to spend six months or a year living abroad, or playing golf two days a week or being at your kid's soccer games, good business practices will lead you there.

InvestmentNews: We are in the middle of doing the analysis now for the 2013 staffing-and-compensation study, and it is hard to ignore the largest expenses that an advisory firm has. It is obviously going to be personnel. When you think about fees and fee structures as they relate to personnel, how should you be looking at your fees relative to your largest expense? Is it something that you should be looking at from an overall firm perspective — the profitability of a firm? Should you be looking at it on a per-employee, a per-professional, basis? Ken, what is the best way to approach assessing whether you are appropriately structured?

Mr. Evans: The best place to start is from the top down. From the study, you can get a sense of how I would tend to organize a set of financial statements. But generally, you want to start looking at your revenue as the top line, less your direct expenses, which we consider to be the cost of compensating the professionals of the firm, the owners and lead advisers — anybody who's client-facing — business developers, those types of people, so less of those direct expenses to get to your gross profit margin. And we want to see those direct expenses totaling somewhere hopefully less than 40% of total top-line revenue. If you have a problem at the gross-profit margin, it can be from a pricing issue or a productivity issue. But it definitely gets you started on the path of understanding some of the underlying issues with your pricing model, and whether or not it's out of alignment. We then like to take a look at the overhead expenses of the firm to get to an ultimate operating-profit margin, which we target around 25%, so that would leave 35% to go to overhead. Understanding those margins and looking at it from that top-line level will get you a sense of where you need to investigate further. Then you can evaluate productivity by adviser, or by office or by team, to get a better sense of where you need to go next.

50/50 SPLIT

InvestmentNews: You can see a pretty decent split — it is almost 50/50 — when you look at the firms that have minimum fees. I thought that there would be a higher percentage of firms with a minimum fee. The average is about $5,800 and the median is about $4,000. It doesn't seem like firms actually are looking at profitability — 71% of the firms aren't looking at profitability for each client relationship, and they aren't necessarily looking at how their fees play a role in that. Dan, what are your thoughts on measuring profitability, what you are seeing when you look at the value of firms, and ultimately, what have you found to be some of the best practices there?

Mr. Seivert: I think to understand profitability, you have to understand cost as an element. We often help firms figure out the cost associated with handling clients, whether it's the direct service or some of the fixed costs involved. It's a little bit easier to figure out how much money you make from each client — the revenue that you generate — but the cost allocation is more difficult. Some of the things that we help firms do — and that we advocate — are to understand the profitability for each of the clients, so we figure out their revenue first and then their related costs, and then figure out the profit. Then the next level up would be to look at it by client size, maybe breaking down your clients into below $1 million or $1.5 million, and then $1 million to $5 million, and then over $5 million in assets, and look at the profitability by client size. Then look at it by client market segment. Sometimes there are niches that you serve. It could be doctors or dentists or pilots, and you might have different marketing activities that have costs associated with going after those markets. Looking at it from those perspectives gives one clues as to where you're strong, where you're weak, and then you can start to ask questions of, how do I get better?

PROFIT PER PROFESSIONAL

InvestmentNews: Sheryl, we are largely talking about looking at the profit and loss here, but how important is it to you, practically speaking, to measure profitability on a per-client or per-professional basis? Do you do it, and is this something that you would recommend that other advisers consider?

Ms. Garrett: It's definitely an old adage that if you can measure it, you can manage it. I think that this is one metric that is really important for us to look at. The prior two panelists talked about the revenues and the costs and the profit per client and so forth, and then segmenting client groups. I would also like to encourage people to measure that same type of activity or success, profitability — "productivity" is probably a better word for it, or efficiency — by measuring your time.

That makes a whole bunch of people cringe. It's not something that I think most of us are gifted at or like to do. But I'll tell you what: It really does make a big difference. It's like telling our clients to track their spending. The more you're conscious about it, the more you're thoughtful about it and make different decisions. Rather than billing a client regardless of how we're being compensated, whether it's a time-based fee or an asset-based fee, I'm a big fan of changing time-based fees. I can look back through my activities and see how much time I spent on this client. I can also determine what costs I had that were only for those clients and then spread the balance across the board. It puts the burden of responsibility of keeping track of your time on the professional rather than the client, which is where I think it should be. But it also enables us to have a couple of bits of information that we need to better estimate and quote fees in the future. Regardless of whether we're doing asset-based fees or time-based fees, if the professional keeps track of how much time they're working on behalf of a client in a time-tracking system and then they measure that against what they quoted the client, they can see how they did in real time compared to what they estimated. Then when it's time for a renewal of a contract to be offered to the client, it may be appropriate to adjust the fee you are charging one way or another to make it more appropriate for the services being provided. That's one important factor. But backing up a step, one thing we need to separate is how we deal with smaller clients or clients that don't need all of the services that we may be able to provide under our traditional service offering. One thing that I needed to separate for myself in my own practice was that I couldn't do the same services, the same package, for all of my clients in these ways and at this frequency, for this price or at this minimum. For many people, that was overkill. I needed to step back and say, what do these people really need? I found myself attracting a lot of do-it-yourselfers, sometimes highly compensated or high-net-worth do-it-yourselfers and a lot of middle-income individuals. I had to really break the traditional mold. I had stepped out of being able to provide full-blown comprehensive planning and portfolio management service to this same group of clients. It would have been not profitable. It wouldn't have been fun, either. They couldn't afford it, nor would they choose to justify a cost for that level of services. Given that these individuals for the most part were middle-income, they did not for the most part have complex financial circumstances — definitely not estate planning and charitable giving and income tax planning. It was pretty plain-vanilla type of financial planning and advice. So given that I didn't have as much complexity, I could streamline my services to these individuals and focus just on what they needed at this point in time.

TIME-BASED FEE

InvestmentNews: Sheryl, there is a question from one of our audience members who uses a time-based fee. The issue that comes up is that such a system makes clients hesitate to contact them and ask additional questions about whether they do those other services. Is that an issue that you face, and how do you handle that?

Ms. Garrett: That is a very legitimate point that I've heard almost entirely from the industry. I never actually heard it from a client. Maybe they never called me. Maybe they never became a client. That could be part of it. But what I did hear from clients were things like one couple who called from the auto dealership. We had done some work together. I knew they were going to be purchasing a vehicle. I got a telephone call, and they said, “We wanted to get your feedback on whether it would be better to take the $2,000 cash-back discount or the 0% financing.” And I said, “Well, can you give me some details, and I'll give you a call right back?” And so 10 minutes later I called them back with, “Here's what I want you to do.” The kind of feedback that I got from those individuals was, “Wow, $40 later and we got a really comfortable answer from somebody that knows our situation.” But there's one huge caveat that I think everyone should put into place if they were to charge by an hour: Nobody wants an open-ended time slot. We absolutely must put a cap on what the high end is going to be. I think the only way time-based billing works for the client, the end-user, is when there is a cap. They know exactly what the maximum case would be. A lot of colleagues that I work with also use some form of time-based billing to compute a flat fee, and they're sharing that very much like an estate-planning attorney might for doing an estate-planning package. They estimate the complexity and how many people are involved, and what documents are going to be involved and the time, and quote a flat fee. That may be hourly or time-based and it may not be — that's dependent on the adviser. But that would be an example of a flat fee or a fixed fee that is based on time and complexity that someone can quote.

MASS AFFLUENT

InvestmentNews: I wanted to get your perspective, Dan, on working with the mass affluent. There is a significant population out there that needs advice, needs that assistance, and yet there's that question, is it really going to be profitable? How do you work with that?

Mr. Seivert: Frankly, a lot of advisers just leave it as an unaddressed point. But of the advisers that do take action, here are the two most popular paths. The first is not doing much to change the service model, but the emphasis is more around having a minimum price or a minimum amount that's paid, whether it's $3,000 or $5,000, regardless of the client's size. Obviously, they move beyond that minimum once they get to a certain size in assets. The other solution that we see advisers taking is coming up with a completely different service model that satisfies the needs of these clients. The emphasis in that model is that it has a lower expense per client or it's at lower cost of delivery for the adviser. The ways in which that comes about are some sort of four to six different model portfolio solutions and very little customization. Instead, there's a high degree of standardization. Another means of doing that is trying to standardize all the service elements with technology as much as they can.

InvestmentNews: There aren't that many customer relationship management options available that actually include some sort of time-tracking component to it. There are stand-alone applications out there. Ken, I wanted to ask you about tracking hours. Do you look at that and would you encourage advisers to be looking at the number of hours that their people spend on particular relationships relative to the fees or the revenue that they can generate from them?

Mr. Evans: Yes, I think it's a great issue to look at. I come from a standpoint, as a consultant, where we track all of our time per client to understand profitability. To Sheryl's point earlier, it was incredibly valuable, particularly to understand the relationship between the services that we're proposing to a new client and what the cost of those was going to be. There is a lot of resistance in my experience to tracking time. It takes a lot of discipline, and a lot of entrepreneurial people aren't into that type of thing. They feel like they have a handle on their business, for better or worse, and they know what they should charge. What we have done in some of those circumstances is to go through a time-tracking exercise for a short period of time — going through different types of engagements or different segments of your client base — and tracking time for a month or a quarter just as a reference point to understand what profitability is looking like. That bridges the gap between no information and some good information about what the cost structure looks like and what profitability looks like.

InvestmentNews: Dan, I wanted to ask you about the impact of some of these online solutions on pricing, both from a client standpoint and from a business operations standpoint.

Mr. Seivert: There's a lot that advisers can learn from some of the user interfaces and the quality of the graphics, and just the digestibility of the way that information is portrayed and reported from some of these solutions. It's really important to look at the technology solutions by the different cohorts or client segment that you're dealing with. If you were to look at marketing strategy or target marketing from real simple terms, you have your older clients, your middle-aged clients and your younger clients. As you might expect, conventionally, the younger clients are going to gravitate a lot towards technology, and you have to be cognizant of how they're interpreting your services and how they might choose you based on the way that they do analysis and decision making. Obviously, you can make the mistake of stereotyping. But some of the generalities do hold. Most older clients are less inclined to pick up the technology and to make decisions based off of it, and instead prefer the relationships. Based on the way your client bases interpret data, the information that they receive is really important. Pricing is going to increasingly show up as a data point on the Internet, and people are going to be searching based off of that. There are certainly companies that are moving in to take the information off of the [Securities and Exchange Commission] reports and to analyze it and to increase the use of that information in the discussion on choosing advisers. For a lot of folks, it's not the greatest of news. But I think one of the things holding that back is that pricing is so complex and there are so many different break points and products — fixed income, equity, success pricing, hourly, financial planning — that it's making it very hard for a lot of the folks that are trying to provide that information. While there is a threat of downward pricing pressure, I think the reality of it is still many years off.

HOW TO RAISE FEES

InvestmentNews: Is there a best practice in terms of how to go about raising fees? Obviously, it is a sensitive subject. Dan, can you tell us your views on a best practice around raising fees?

Mr. Seivert: Well, it ends up being kind of a combination of a technical issue and a personal issue. Some advisers feel that they're making a fair amount for the service that they're providing. When you have a $2 million client at perhaps a 1% fee bringing in $20,000 a year off of that client, some advisers say, for what I'm doing, that's more than enough. Other times, they're doing so much work for that client that they don't think that's enough. The other technical side of it is looking at how much you charge, versus what others in the industry are charging for a similar service. In the studies that we see, we can get a sense of what other advisers are charging for certain sizes and other specific cuts of the data, but what's more difficult to figure out is the actual service being provided. For those advisers that conclude that they should raise prices, but often say, "Look, I can't do that; there's no way I can increase my prices," we help them do that and put the emphasis on the definition of value, which is really the benefit over the cost to provide it. Too many times, advisers aren't emphasizing the benefit of what they do. We feel that if you roll out a pricing change and emphasize a handful of new benefits that feel great to clients, and they really value those, that's the way to do it. If you're just increasing the price and everything else is the same, it does make it more difficult. Sometimes you can just polish up the long list of things that you're already doing, and maybe clients don't know all those things. If you emphasize all the great things that you're doing, then that can certainly help. But just raising the price, and not emphasizing all the benefits as well, can be tough. In general, we've found that once advisers do raise their prices, they look back and they say, "I should have done that a long time ago; that was way easier than I thought it would be."

InvestmentNews: I imagine it is a very difficult decision to raise fees and then even more difficult to communicate to your clients. Sheryl, have you approached this in the past and what have you done if and when you had to raise fees?

Ms. Garrett: I have, and it wasn't pleasant, but the end result was a lot easier than I expected every time, and that's what I have heard and seen from others. I would love to see our industry separate financial planning fees from investment advice if they're done as a separate activity. Bob Veres of Inside Information newsletter did a survey and indicated that about two-thirds of folks do charge an upfront fee. If clients choose to sign on with them, about half of those individuals waive that upfront fee. So it's a bit of a challenge there. I would like to see financial planning uplifted as much as we can as a profession. Those services are so valuable — knowing when to start a Social Security distribution or whether to take a lump-sum distribution from a pension plan — those are critical financial planning decisions that could have a much more significant impact on somebody's life than what we can bring to the portfolio decision. I'd like to separate those fees. By separating them, we can more clearly keep the more intangible financial planning subject matter in an area and isolate what these services are. It's more of a comfort factor. Am I on the right course? How am I doing? What could I be doing better or differently? It also enables us to get paid for all of our work by charging for the time that we spend on those financial planning activities. For the investment portion of the portfolio, that could be charged in a number of different ways, whether that is a time-based or an asset-based fee. By separating those two segments of services we could be providing, we'll make raising or changing fees much more clear to the individual parties. I'm seeing — and I haven't seen this trickle down into the industry as much as I hear talk of it occurring, and I feel that we're on the edge of it — that asset management fees are a commodity. We've heard that phrase before, and as more and more third-party advisers and separately managed account managers come forward, and we have low price options, we may not want to tie ourselves to an AUM pricing for all of our goods and services. It might be healthier for us in the long run — maybe a little bit more painful in the short run — to separate those financial planning activities. Pick a fee — however it's structured — that you're uncomfortable with. I'm taking it for granted that you guys are a little bit like me in the sense that you're not going to come out of the chute with an overpriced service, that you really have to stretch to actually charge what you're worth. I find that to be quite common, that many of us undercharge naturally. We tend to be a bit too altruistic, and it's our obligation not only to survive but to thrive, to take care of our clients in the future. We've got to stretch for something that's uncomfortable for us initially, and then don't increase your fees more than every other year. If you're trying to build up a regular relationship with people — and all of us are, whether we're charging hourly or AUM or a retainer — we all want long-term relationships with people we care about and like. So if we're seeing them quarterly or monthly or at least once a year, I wouldn't want to have to go, "Oh, by the way, I'm raising your rates again." I want to stretch myself enough that I'm going to be good for the next two or three years before I have to raise my rate again. I want to keep my fee structure as simple as possible and easy to explain and repeat. Not only is it easy for me, but it's easy for my clients and other people to say, "Contact Sheryl. She can handle that question or work up a full-blown comprehensive financial plan. She just charges you by the hour, $240 an hour." That's easier to explain and then helps to set the expectations and communications. Let folks know what's going on with you. I don't necessarily know that you need to make any rationalization for raising your fees when they're broken out. You're keeping track of your time, even if you don't apply that fee schedule to it. You can use your experience of, "I kept track of my time, and based on the retainer fee that we had last year, you came out well ahead, dear client, and it's appropriate for us to adjust that accordingly."

THE FINAL WORD

InvestmentNews: I just wanted to give you, Ken, the final word on this issue of raising fees and a couple of points for our audience.

Mr. Evans: One, know your own worth and be confident in what you deliver. We talk to advisers at conferences or other events, and everybody has a unique way to approach the market, and they're confident in their abilities and that what they do is different. A lot of times, advisers can get a little weak-kneed in front of clients. Know your self-worth in front of clients and be willing to toe the line with fees or with raising fees. Know what you do provides value and ultimately is a very good thing in their life. Then, coming from a research perspective, I would get my hands on information that gives me a sense of confidence that what I'm going to market with is fair. I would use the resources that are available to you, whether it's studies, ADV Part 2s, [or] proposals that you see from other asset managers or financial planners. Use all that information, have somebody take a look at it in your office, and run the numbers and see where you fall. With that, you'll have some confidence that what you're doing is fair.

Daniel Seivert

Managing Director

dseivert@echelon-group.com