The Road Less Traveled: Fee Structures

Zararin neresinden dönülse kardir.
(No matter how far down the wrong road you have gone, turn back).
– Turkish proverb

Executive Summary

Part I: Old school wealth management.

Part II: While the services provided by the industry changed, the fee structure retained its antediluvian state.

Part III: Much distinguished advisors from brokers, but the billing structures remained too similar.

Part IV: Under the legacy method of charging fees, incentives are too often misaligned.

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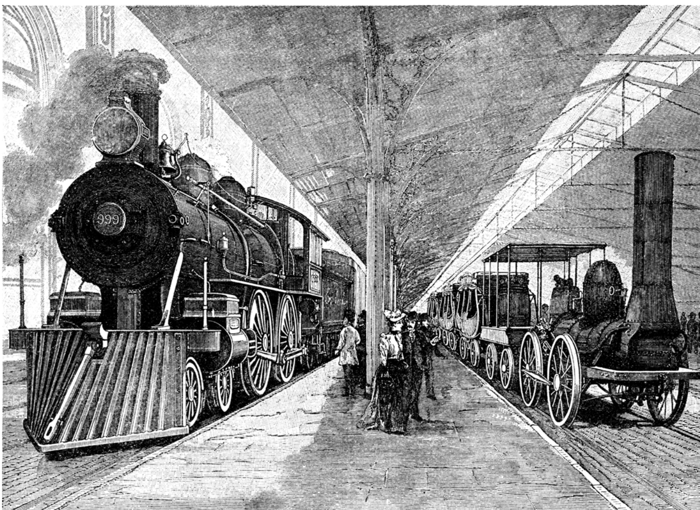
PART I

Old school wealth management.

Generally speaking, the wealth management industry and comprehensive financial planning had their roots in the stock brokers of the early 20th century. Wealthy individuals from prominent families rode trains into metropolises and ascended recently constructed skyscrapers in newfangled elevators in order to sit in the plush leather chairs of big-time city brokers who might have been intelligent investors with true institutional advantages, but more often than not were mediocre rent-seekers or glorified snake-oil salesmen. The broker, or self-described "advisor," recommended the investing in or divesting of stocks. They filled out on paper an order to buy or sell, and then sent scrambling to the broker's window a young Jesse-Livermore-wannabe so the trade could be processed at the new 18 Broad Street headquarters of the New York Stock Exchange.



The wealthy then walked down the street to the accountant's office to sort out the details of the just-passed Sixteenth Amendment, which granted Congress the power to collect income taxes. Thereafter, it was on to the lawyer for a primer on the modern version of the estate tax, also recently passed. Finally, came the insurance agent, the most adept fleecer of all![1] Note that, as we've recounted it,

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this was an ad hoc process with little communication between the professional advisors, and practically no interactive comprehensive financial planning. It was a team without a coach—with no one to designate the starters, call the plays, and request reviews of contentious plays. The Rockefellers could afford to employ a coordinated assembly of financial and legal professionals within one "family office," but most clients were left to fend for themselves. ❧

[1] Just kidding! Insurance agents can be good people, too.

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PART II

While the services provided by the industry changed, the fee structure retained its antediluvian state.

The payment of fees to these parties differed. The broker who bought and sold securities on his clients' behalves earned a commission, as did the insurance agent when assisting in the purchase of a policy. Meanwhile, the lawyer and accountant probably charged clients via retainer, billed hourly, negotiated a fixed fee, or relied on some mix of the three. The broker's fee made some sense at the time since the bulk of their value-add stemmed from enabling the purchase of securities (at the time, at a level of difficulty that may have resembled the contemporary purchase by an American of a share of Standard Bank Group on the Johannesburg exchange). Although the broker may have advised purchasing one security over another, they were not—or at least should have not—been considered a trusted counselor bound by the fiduciary standard.[2] Consider your understanding of the salesperson at the mattress store. As people, most of these folks are honest and well-meaning. In their interaction with customers, they are likely to portray themselves more impartial and less commission-driven as this approach builds trust with clients. However, as a customer, you understand that the mattress store employee is ultimately there to facilitate a sale, duly encumbered with strong economic incentives to close the deal. The customers appropriately "discount" or "filter" the salesperson's advice. So it was with the turn-of-the-century broker. Their stock picks should have been taken with a grain of salt.

...An object in motion continues in motion until acted upon by another force.

Over time, technology commoditized securities transactions. These days, who needs to pay a broker when one can buy shares through Schwab and Fidelity for $4.95, or seemingly for free at Robinhood? In order to maintain clients in the face of this onslaught, the broker began to offer more advice. In addition to investment management strategies such as diversified asset allocation, they assisted in the planning of taxes, retirement savings, cash flow management, and ultimately any other decision that affected their clients' financial well-being. All the while, most continued to be paid by commission. Their job function had substantially morphed into one more similar to the lawyer's than the insurance agent's, but brokers still billed as if they were salespeople. Why? The same reason football coaches continued to punt on fourth-and-short despite clear sub-optimality—Newton's first law…an object in motion continues in motion until acted upon by another force. That's the way things have always been done, the coaches thought. It's tradition, and it's how all my peers do it. Who am I to go against history, forgetting that history is fallible and mutable. Technically, most advisors were still brokers within wirehouses like Merrill Lynch, and wirehouses were setup to earn revenue via commission. True, much of the advisor's value now came from comprehensive financial planning, and yet they were still paid as if their primary function was to facilitate the buying and selling of stock.

[2] This did not preclude the possibility of a fantastic broker-investor. Warren Buffett was at one time a stock broker, but subsequently abandoned that structure for one more conducive to optimal investing.

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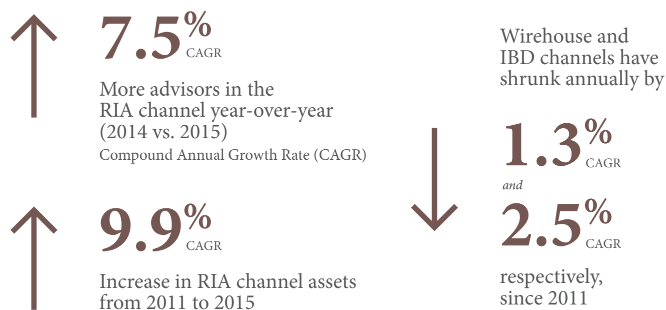
Several decades ago, forward-thinking advisors (né, brokers) discarded the conflict of interest inherent to commission-based pricing and became Registered Investment Advisors (RIAs). RIAs were independent of any wirehouse, such as Morgan Stanley, and were compensated directly by clients only for the advice they provided. No commissions allowed.[3] They were free to recommend any stock or fund to their clients, regardless of which financial institution facilitated the transaction, managed the fund, or custodied the security. The Morgan Stanley advisor may be incentivized to buy and sell a Morgan Stanley mutual fund, with Morgan Stanley acting as the broker, and then custody the asset in a Morgan Stanley account. Quite a boon to Morgan Stanley's bottom line. The RIA might recommend a fund managed by First Pacific Advisors, with Charles Schwab as the broker, and then custody the security in a trust account at Bank of New York Mellon. Alternatively, they could select any other fund and affect the transaction and custody of the shares at any other broker and custodian. In fact, if they truly believed it to be in the best interest of their client, they could buy the Morgan Stanley fund with Morgan Stanley as the broker and custody the security at Morgan Stanley. The key point is the RIAs were free of the constraints and misaligned incentives of the wirehouse broker.[4] ❧



Source: Charles Schwab

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[3] As one might expect, it could be more complicated than that. For example, an "advisor" might provide non-commission (a.k.a., fee-only) advice regarding investments, but then earn a commission by selling insurance to the same client. We focus on the simplified model here, especially because it accurately describes Gryphon as we earn no commissions whatsoever. No stock brokering, no life insurance, no annuities. Nothing.

[4] Recalling that Morgan Stanley has a cadre of lawyers who, now almost a decade removed from the Great Financial Crisis, likely have much free time on their hands, we'd like to assert we bear no ill will towards the august institution co-founded by J.P. Morgan's grandson. We use the firm merely for illustration as its fame is so widespread as to conjure the correct image in the minds of the general public.

PART III

Much distinguished advisors from brokers, but the billing structures remained too similar.

The question now arose, how should the new breed of comprehensive planners charge their clients? The advisors functioned much like the Rockefellers family office, except they served numerous families (a "multi-family" office) and offered less sophisticated advice. (Establishing a Qualified Personal Residence Trust might be relevant, but not managing a fleet of private jets). Their "fee-only" compensation was paid directly by their clients. Whereas brokers received a FINRA-administered Series 7 license that allowed them to sell products, an RIA employee earned a FINRA-administered Series 65 that allowed them to sell advice. RIAs were held to the fiduciary standard, meaning that they were required to act in the best interest of the client. Brokers were held to the suitability standard, meaning that they were only required to sell suitable products, even if they were aware of better, lower-cost alternatives.[5]

Logically, it would seem as if the RIA should have a fee structure more like the lawyer and less like the broker. The advisor thoroughly researched numerous solutions, factored in the relevant constraints, crafted a comprehensive strategy, and then assisted in the execution of that plan. There was very little cold-calling

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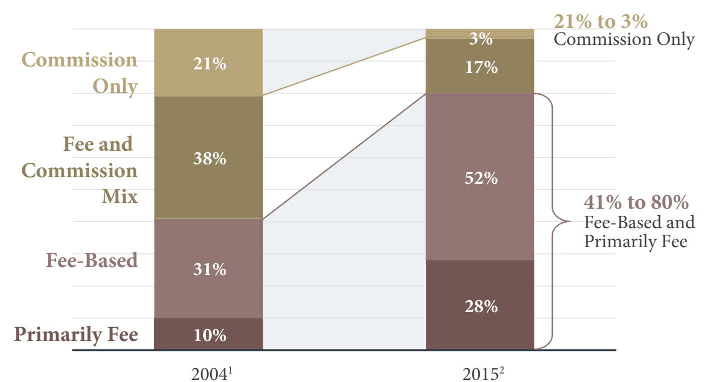
and account churning. However, the hold of the old model, with compensation explicitly tied to the client's portfolio, was strong. As former (or reformed) brokers, these new RIAs had spent much of their professional lives in an environment where compensation was tied directly to investment assets. In addition, the mutual funds into which many advisors recommended their clients invest charged a percent of assets under management (AUM). Under these influences, many RIAs opted for a business model that tied their entire fee to a percent of assets under management. In other words, if the RIAs advised on the investment of a client's $10mm portfolio, they might bill 1% on that AUM for an annual fee of $100,000. This fee was also meant to cover the other planning services, such as tax, retirement, and insurance. This was in lieu of a retainer, hourly, or fixed fee that accounted for the full suite of services rendered, including those beyond, and maybe more important than, investment management. ❧



Advisors by Revenue Source

[1]Advisor Portfolio Construction Dynamics, Cerulli Associates, 2011.
[2]Advisor Metrics 2015: Anticipating the Advisor Landscape in 2020, Cerulli Associates, 2015.
Source: Fidelity

[5] For example, imagine a client wants to invest in the S&P 500. There are two effectively identical index funds, one from Low Fee Investment Co that charges 0.10%, and one from Mr. Potter's Investment Co (formerly a division of Goldman Sachs) that charges 0.35%. A broker working at Potter's could legally purchase the latter fund because it's suitable – it gives exposure to the S&P 500 – while the RIA would probably need to recommend the former because it is clearly in the client's best interest to pay less for essentially the same product.

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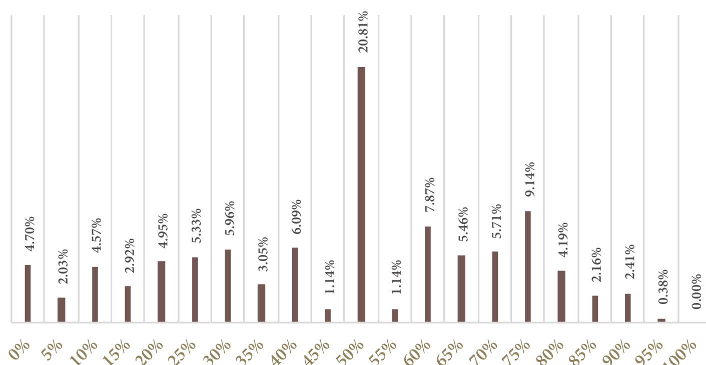
PART IV

Under the legacy method of charging fees, incentives are too often misaligned.

While understandable, this billing structure is suboptimal for a number of reasons. First, it assesses the entire fee against only a portion of the value-add. While the breakdown differs across engagements, a back-of-the-envelope calculation estimates that investment management is about a third of value-add to most clients. Tying the entire fee to this single slice instills in some clients the false belief that we are being hired chiefly to manage an investment portfolio, and the other services rendered are a mere courtesy like the bread that restaurants used to bring to a table before the meal. Viewing retirement and estate planning as add-ons is akin to considering bypass surgery as a service, and the subsequent recovery in the hospital as a mere courtesy. Get rid of the bread and your dining experience is not noticeably worse. Roll the patient from the operating table to the street, and they're dead.

Secondly, an AUM fee may have a tenuous correlation with the extent of services rendered. Imagine a client with a $10mm portfolio. Last year, their financial life was tranquil so their advisor devoted only a hundred hours to the engagement. The client was charged 1% of AUM, and thus paid $100,000. This year, the client's small business was purchased by a publicly-traded competitor and they became an executive at the larger firm. Significant planning went into the structuring of the sale and much advice was rendered on their new compensation scheme at the publicly-traded firm because of variables such as restricted stock, an employee stock purchase plan, and a deferred compensation plan (not to mention new insurance, an H.S.A., etc). This required two hundred hours of work. Meanwhile, the investment portfolio appreciated 5%, and so the fee increased by $5,000. The proportions seem off. Would one pay their babysitter $60 if one day they watched the kids for three hours, and then $63 the next day when they watched the kids for six?

Advisors reporting % of AUM Fees That Pay for Non-Asset Management Client Services (Financial Planning etc.)



Source: 2017 Inside Information AUM/fees Survey, Bob Veres – 2017 Planning Profession Fee Survey

Keep in mind the same client. A year from now, their complexity reverts to the hundred-hour level with one exception; they inherit $10mm, which is deposited into their investment portfolio. As a result of this increase in AUM, the client's fee rises from around $100,000 to over $200,000. How should one think about the babysitter if one day they charged $60 to watch both kids for three hours, and then the next day charged $120 to watch just one of the children for the same amount of time?[6] Does this sound like a sound compensation structure? Maybe, over the long-run, it all gets evened out in the wash, but why pursue a suboptimal strategy and hope it works out? Instead, why not craft a thoughtful plan that can prudently be expected to yield a mutually beneficial outcome?

Why pursue a suboptimal strategy and hope it works out? Instead, why not craft a thoughtful plan that can prudently be expected to yield a mutually beneficial outcome?

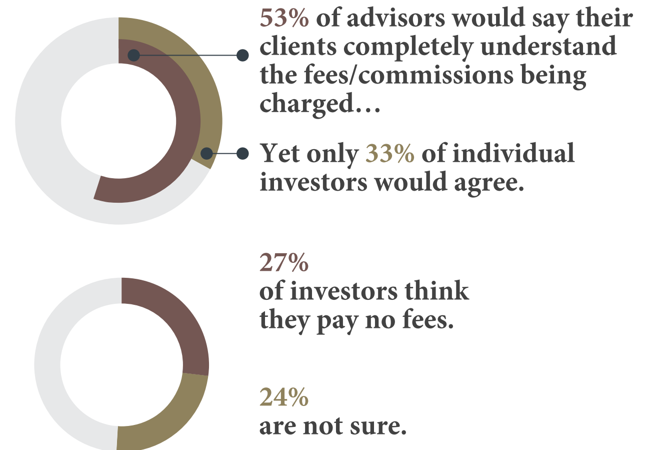
[6] This sort of incongruity is in other professions, such as the real estate agent whose commission for a $10mm sale might be double that of a $5mm sale even though the effort expended is substantially similar.

Finally, the percent of AUM compensation structure creates an incentive for the advisor to gather investment assets, possibly at the expense of more optimal solutions. For example, a client may have the option to pay an annual $10,000 premium for disability insurance, or invest the money and self-insure. In the latter situation, the cash is added to the AUM pool, and thus increases the advisor's fee. In the former situation, the premium might be withdrawn from the investment portfolio, and therefore decrease the advisor's fee. A skewed incentive exists.[7]

This is not to assert that the percent of AUM model is without merit. For example, most clients have in their investment accounts the bulk of their non-personal-residence net worth. As the value of these investments rise, the client is significantly better off, just like they are when they implement a robust estate plan or gift away low basis stock to avoid a capital gain. By tying the fee to the appreciation of the investment accounts, in some ways the advisor's incentive is aligned with the client's.[8] It's even possible that under a commission scheme an honest and educated broker could do better for their client than a fee-only RIA. Heck, the Baltimore Ravens won a Super Bowl in January 2001 with Trent Dilfer as their quarterback. (He had 12 touchdowns and 11 interceptions). Outliers are possible, but hoping for them is not a reasonable approach. When it comes to getting rich, we'd recommend hard work over playing the lottery. One is logical, the other is a crapshoot.

At Gryphon, we understand the underlying rationality of optimal fee structures, but also that each situation necessitates nuance, which may require a partial deviation from the pure logic. Certain of our relationships, such as investment-management-only, are best served by an AUM fee. Others, such as a one-time estate settlement, are suited towards hourly billing. A comprehensive planning relationship lends itself to a fixed fee. Some engagements require all three. The point is to be thoughtful, and not a lemming, so that you avoid going too far down the wrong road. ❧

Advisors often overestimate the degree to which investors actually understand their fees.



Source: State Street Global Advisors' Survey, 'Financial Advisors'. Value Proposition and Compensation' August 2014.

[7] Of course, RIAs are bound by the fiduciary standard, and most are highly ethical, but the power of the law and the better angels of our nature often buckle under temptation.

[8] Even here, the link may be tenuous. If an advisor simply purchased an S&P 500 index fund for their client on 10/31/2012, the investment portfolio, and the advisor's fee, would have both risen by 15% annually over the following five years. Good on the advisor for selecting a high-return asset class, and that's worth something, but is it really worth an annual 15% raise?

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