How Much Are You Paying Your Advisor?

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A recent survey by Cerulli Associates and Phoenix Marketing International found that nearly two out of every three investors in the survey were confused about how they were paying their advisors. According to a survey released in October by investment management firm Rebalance IRA, many Americans incorrectly believe they pay no fees in their retirement accounts. A recent SEI survey of consumers also finds that 38 percent of mass affluent consumers are 'either wrong or confused' about how they compensate their advisor.[1] Why the confusion? The brokerage industry has spent years disguising fees.

Brokers and their firms charge in a variety of ways. Hopefully this article provides clarity on the topic by answering a few simple questions.

How do advisors get paid?

- Fee only: An advisory fee based on a percentage of assets under management. The advisory fee typically ranges from 0.5 percent to 2.0 percent of the amount invested, rate is generally influenced by asset size and services provided.

- Commissions: A sales load or transaction fee tied to the product sold to the investor. The potential for a conflict of interest does exist. A broker could be tempted to recommend an investment offering the highest personal payout.

- Fee based: Advisors receive compensation from either model. The advisor may choose which method of pay or could even provide the client with an option to determine how they would like to pay for advice.

Clients are often uncomfortable discussing fees and asking how the advisor is compensated for the services provided. But discussing fees with your advisor is not unreasonable—it should be encouraged and part of any routine review of your financial plan. In fact, your advisors should be able to provide a clear concise description of how they are paid. If your advisor cannot clearly explain his or her fees and compensation—you should reevaluate the relationship.

Other than the fee your advisor charges, what additional fees could you be subject to as an investor? Whether you utilize an advisor or not, you are likely paying several of the following fees listed below:

- Expense ratio - Mutual funds, ETFs and even no-load funds carry an expense ratio. This is generally a small percentage. Revenue sharing arrangements may exist, particularly with discount brokerage firms. While the discount brokerage firms may charge a lower annual advisory fee, the true cost of the relationship may be similar or higher than the independent RIA model, particularly if the underlying investments consist of mutual funds.
- Transaction fee - Your account is charged every time you buy or sell. Such an arrangement is common in the traditional brokerage model. This charge is also known as a commission.
- Plan fee – Common in 401(k) or company sponsored retirement accounts, your plan provider may charge this fee for holding your assets or providing plan administrative services.
- Wrap fees- Prevalent in a brokerage model. A broker may invest your funds in a basket of individual stocks, and you will pay fees to a third-party manager. A portion of these expenses will be passed on to your advisor as compensation.

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[1] http://www.thinkadvisor.com/2016/02/04/higher-fees-wont-spook-most-advisory-clients-sei#.VrpRXO1-tZc.twitter

- 12b-1 fees - Assessed by a mutual fund, the fee provides compensation to a broker or brokerage firm and is paid directly from the fund company.
- Sales loads or redemption fees - Sales loads are taken from your initial investment and passed on to the broker. Back end redemption fees may be assessed when an investment is not held for a pre-determined period. Redemption fees are typically attached to 12b-1 fees or a high expense class of mutual fund shares. The redemption charge is created to ensure a minimum rate of compensation for the broker, allowing the investor to bypass an upfront charge on the investment.

The various types of fees can be confusing. It may be helpful to walk through a few scenarios to compare and contrast the different models.

Example: Client A contacts his broker and expresses an interest in investing $50,000 in U.S. growth stocks. The broker invests the client assets in Fund XYZ which charges a sales load of 5.75 percent with operating expenses of 0.68 percent annually. The client will immediately pay a one-time fee of $2875 on the trade on top of the recurring fund management fee. In this case the suitability standard has been met. Client B contacts his Registered Investment Advisor with the same request. The investment advisor purchases an ETF with a gross expense ratio of 0.18 percent and pays a commission of $8.95 on the trade. This client pays his RIA a management fee of 1 percent of the assets, which equates to $500 per year on $50,000. The advisor has met the fiduciary standard. In our very realistic example, the front-loaded fees paid by Client A are significant enough that it would require a commitment of approximately nine years to this fund family before that commission is equal to the sum of advisory fees paid by Client B.

Let's look at another scenario to illustrate the difference between a brokerage model and a true fee only model.

Example: Client A is approached by his broker to invest in a non-publicly traded real estate investment trust. The client sends in a check for $100,000, and the security is priced at $10 per share, thus the client receives 10,000 shares. The broker receives a 7 percent commission from the real estate investment trust sponsor. Client B is approached by his RIA to invest $100,000 in the same privately held REIT. The advisor charges a 1 percent management fee and does not accept compensation from the REIT sponsor. In this scenario, the commission is returned to the RIA client in the form of a reduced purchase price for the shares. Client B receives a discounted price of $9.30 from the sponsor and is able to purchase 10,752 shares of the same REIT with his $100,000 investment. Client A would be required to hold the investment for approximately seven years before his 7 percent commission matches the sum of fees paid by Client B to his advisor.

What about the discount brokerage model; how could the revenue sharing arrangement impact your cost of advice?

Example: Discount brokerage firm XYZ offers to manage client assets at a reduced cost of 0.80 percent of assets under management for Client A. The rep at XYZ purchases $150,000 of retail shares of a bond fund with an operating expense of 0.75 percent. The rep does not receive compensation for choosing this fund; however, his firm (XYZ) receives revenue sharing directly from the fund company. A registered investment advisor for Client B charges 1 percent for his services and purchases institutional shares of the same fund with an operating expense of 0.46 percent. RIAs often have access to the lower cost I shares offered by certain mutual fund families. In this scenario, the "discount" brokerage relationship results in a slightly higher cost to Client A because of hidden revenue sharing, despite charging a lower management fee for their service.

The comprehensive list of fees and expenses an investor could pay his or her advisor is extensive. It is easy to see why many investors are confused and frustrated with their attempts to determine the cost of their advisory relationship. A variety of online tools are available to help you understand the expenses associated with your underlying investments; however, if you are not familiar with industry jargon and investment terminology you may become exasperated searching for the answers.

OJM Group's Wealth Management Team is willing to perform a fee audit to provide an answer to the question: what am I paying my advisor and is the amount reasonable? Leverage the resources of our team, and transform yourself into one of the few investors who know exactly what you are paying your financial professional.

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