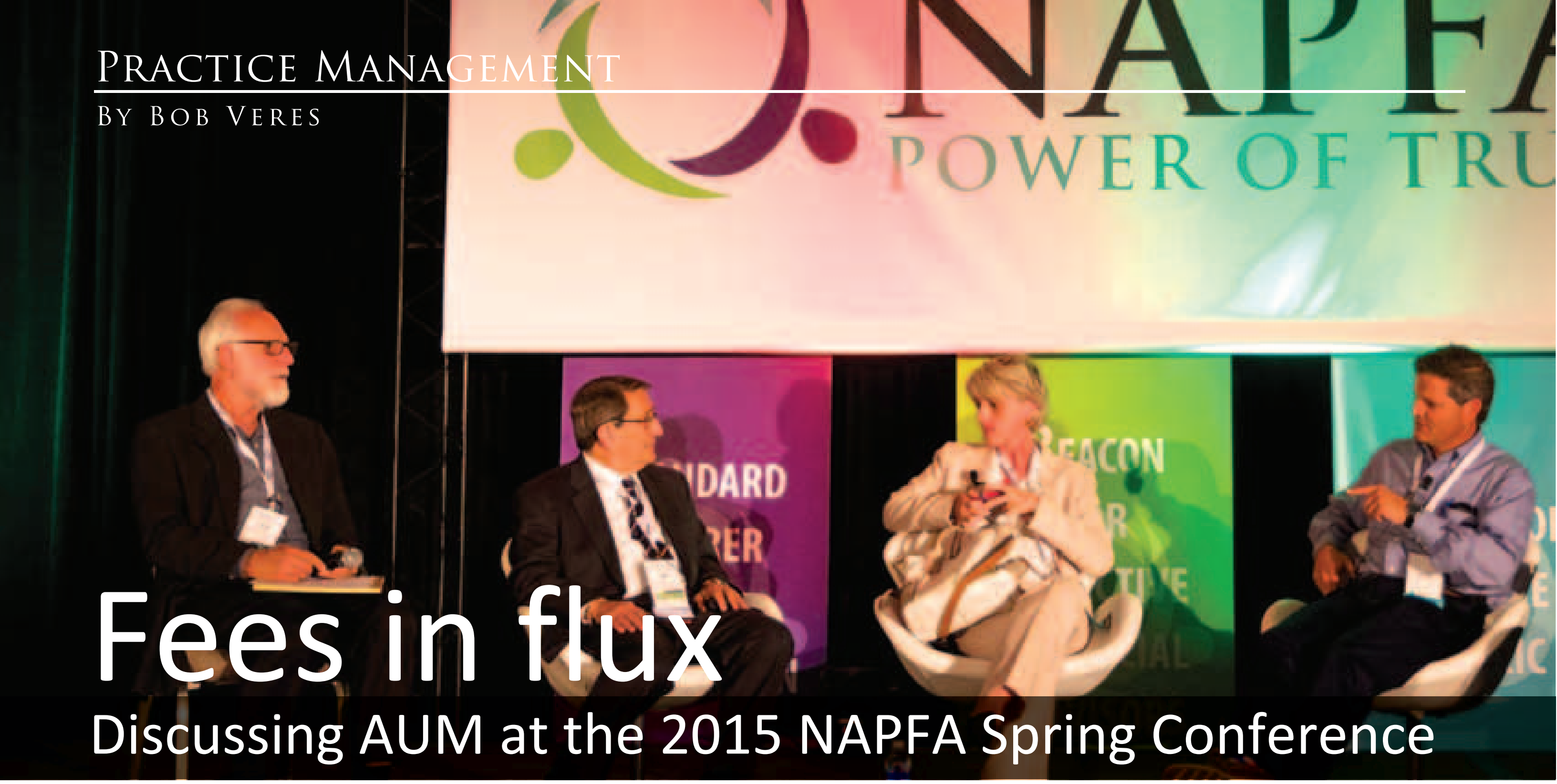
BY BOB VERES



Fees in flux

Discussing AUM at the 2015 NAPFA Spring Conference

This article was originally published in Bob Vere's June 2015 "Inside Information" newsletter. This is an abridged and edited version.

For at least 15 years, I've been predicting that the financial planning profession would evolve from the AUM revenue model to some combination of retainers and/or hourly, and leave behind a variety of conflicts of interest. Now, I think we may finally be on the cusp of that major shift. New technology, in the form of online advice platforms (the so-called "robo-advisors"), is finally nudging the profession off of the comfortable AUM model. These firms are telling the world that they charge 15 to 25 basis points to manage assets, while "greedy" advisors charge 100. Advisors know the fallacy in this claim: that only about 15 to 25 basis points worth of their value (if that) can be attributed to their asset management work. The rest of their fees pay for financial planning services.

But until planners' compensation models reflect this division of value, their clients and prospects are going to find the robo-argument persuasive. Many advisors already know that they're going to have to move off of the AUM model sooner or later. The big question in their minds is: how?

Value-based compensation

At the 2015 NAPFA Spring Conference in San Diego, I hosted a panel discussion that explored issues around alternative fee structures. Participants included Roy Diliberto, founder of RTD Financial Advisors in Philadelphia, with 500 clients and 23 employees; Carolyn McClanahan, of Life Planning Partners in Jacksonville, FL, with three advisors and just over $100 million under management; Mark Berg, founder of Timothy Financial Counsel in Wheaton, IL, which has four CFP® advisors and 400 clients; and Jacob Kuebler, a Partner at Bluestem Financial Advisors in Champaign, IL, with 57 clients and two advisors.

At the beginning of the packed presentation, I asked for a show of hands: "How many of you, in this audience of about 220 advisory firms, are currently following the AUM revenue model?"

Virtually every hand went up.

"How many of you," I asked, "are considering a switch to a different revenue model?"

Virtually every hand went up.

Then I asked each panelist to tell us the story behind their own switch from AUM to their current model.

Diliberto said that AUM is a close cousin to the sales model. "Imagine walking into a concierge doctor's office," he said. "The doctor tells you about all the things he's going to do for you, and you're pretty excited because this is exactly what you wanted. Then you ask, how much is this going to cost me? And the doctor leans over and says: Don't worry about it. All I ask is that you buy the drugs from me.

"People in our profession," he said, "have been selling drugs and giving away our core competency. To me, it makes zero sense to throw in your core competency for something else that is pretty damn easy to get. If you want to communicate to clients all of the things you do, and the value of those things, then in my opinion, you have to have a fee structure that demonstrates that."

Diliberto had been reluctant to make a switch. Eventually, he said, he told his partners that he was putting a retainer-only fee schedule in the ADV. It worked so well that in six months the entire firm abandoned the old policy and went to the retainer model.

As a former doctor, McClanahan is well-acquainted with the fee-for-service revenue model. When she entered the planning business, her first clients were younger physicians who had accumulated more debt than assets. "I was doing a lot of work for them and not getting paid," she said. "That just never felt right to me. But my number-one complaint with AUM was that it put too much focus on investments when the main value is in the planning."

She switched to a flat retainer model in 2007, just in time to avoid the downturn. "I didn't do it to protect myself from market fluctuations, but it did," she said. "I did it because I think a flat retainer structure helps to train clients that the importance of what we do is financial planning, of which investment management is just a part."

Berg told the audience that he switched because he got tired of turning away 80 percent of the prospects who knocked on his door. "During my first six years, I worked with one of the largest RIAs in the country," he said. "I loved the firm, but I always struggled with the fact that I could only serve a certain type of client. Out of maybe 10 people who would come to us through referrals, eight of them didn't fit."

After looking for three years for a firm that he could refer those people to, Berg took a decisive step. "Finally I struck out on my own, didn't take any clients with me, and decided, as I looked at all the different options out there, that hourly probably could fit the whole spectrum," he said. "The need is massive."

Bluestem switched because the AUM model made little sense for the clients it was serving, and because retainer compensation was a key part of the culture of the Alliance of Comprehensive Planners. "We're in a university town and work with a lot of professors," Kuebler said. "The AUM model never made sense for our client base. The professors have most of their retirement money in TIAA-CREF—and also our firm is very focused on doing tax planning—and the AUM model doesn't really show value in the tax preparation."

Kuebler also likes the fact that the retainer model is flexible enough to allow him to work with his generational peers. "My target clientele is people like me: the young professional," he said. "They don't have assets to manage. The retainer model really makes sense because I'm allowed to charge based on my client's total situation, and the value that I add. It's a value-based fee system."

Determining fees

Perhaps the most daunting aspect of a retainer model is the perceived complexity of it. How does an advisor eyeball a client situation and determine, up-front, what they're going to charge? In addition to requiring more judgment than a simple AUM calculation they can do in their heads, retainers put advisors at risk of offering a fee that is much lower than the work would ultimately justify.

Initially, RTD, where Diliberto is a partner, had each advisor determine what to charge their clients. "The result was that some people were being billed more than others for basically the same services," Diliberto said.

RDT now uses a formula that starts with a minimum fee of $10,000, and goes up based on a client's investment assets. "We tried to calculate based on a client's net worth," Diliberto said, "but the problem is that it gets complicated. …The only thing that we can absolutely, positively measure is investment net worth."

> **"If we don't talk for six months, then they [the clients] don't get any bill."**
>
> **NAPFA-Registered Financial Advisor Mark Berg**

Here are the basics of their system. "If your investment net worth is less than $1 million, your fee would be $10,000. The fee goes up by $1,000 at various asset tiers. That fee is fixed for three years," Diliberto said. "At the end of three years, we go back and apply the formula again, and let them know what their new fee is going to be."

"Our minimum fee is $5,000. For that retainer, we manage everything—the outside 401(k)s, 100 percent of our clients' assets—and then on the planning side, we have an ongoing planning process," she said.

The fee goes up, for example, if a client is married, has children who will attend college, has to care for elderly parents, has a business, and so on. Then McClanahan takes account of a client's assets, including how they're structured. More complexity (but not necessarily more money) means more basis points. The retainer applies for two years, and then the formula is applied all over again.

Kuebler's path at Bluestem was more complicated. The firm began with a formula that was income- and net-worth-based, he said, and later moved to a system with six tiers. The firm eventually decided that the best proxy for their clients' complexity, and the value that they were adding, was total net worth—with a twist. Their fees are adjusted upwards or downwards buy either 10 percent or 15 percent, based on six different complexity factors.

Berg's firm charges by the hour, but the fee structure varies depending on the type of client and on who will serve as the lead planner. Berg uses five client levels that encompass everyone from small business owners to the most straightforward situation. From there, it's pretty simple, with clients being billed monthly for the number of minutes that advisors spend working with them.

"If we don't talk for six months, then they don't get any bill," said Berg. "On the other side, I have clients where we will bill 100 to 150 hours a year, because we're really getting involved in their businesses. The complexity takes care of itself."

Into the blue ocean

What are the business advantages and disadvantages of moving off the AUM revenue model? Diliberto stated the obvious: that a retainer model insulates a practice from 2008-like downdrafts in the investment markets. "The retainer model creates a more predictable stream of income than AUM," he said. "But you have to be careful about the timing."

McClanahan added that the leveling of compensation helped focus her client meetings on the important issues.

RTD and Life Planning Partners manage assets in the traditional way that AUM advisors do: on a discretionary basis through an institutional custodian. Timothy (Berg's firm) offers investment advice but doesn't manage the assets or create performance statements, a model that happens to be preferable for the large number of potential clients who don't want to delegate full control of their investment portfolios.

Berg said that he likes the fact that he can now work, profitably, with those eight out of 10 clients who are turned away from the typical planning firm, either because they don't have a lot of assets or they aren't interested in delegating. "The blue ocean is massive," he said, "and there are very, very few in our ocean. There's a lot more room, and we'd welcome you."

Kuebler reiterated the blue ocean advantage: the retainer model allows Bluestem to work profitably with college professors and younger professionals who would be turned away by firms who charge by AUM. Bluestem advisors meet with their clients anywhere from six to 10 times in the first year, with each meeting focused on one particular area of their financial life. "They're not just hiring us for our expertise," he said. "We represent a way where they can buy time back for themselves, by offloading some of the work to us."

Berg and McClanahan also find that the flexibility of their non-AUM model helps clients with tax issues. "We have lots of clients who wouldn't get over the 2 percent of income threshold, either because they're high income, or maybe they're retired and wouldn't otherwise itemize," said Berg. "So clients love to prepay us in December for the upcoming year, to get two years of fees in one year, get over that 2 percent threshold, and take that tax deduction."

Ongoing service

Finally, the panelists felt that their non-AUM revenue models addressed another big problem in the profession.

"We pick up lots of clients from Fee-Only advisors who charge AUM," said McClanahan, "because they did an initial financial plan and then never revisited it."

McClanahan reviews each part of her client's plans throughout the year and sends the clients the reports. "We save them tons of money. If we had been doing just reactive planning, we wouldn't have saved them that money."

Kuebler used to worry about this ongoing value issue, especially with younger professionals. But when he asked one client if he'd prefer to have fees deducted from his account, the client responded that writing the check every year forced him to think about why he'd hired Kuebler in the first place and the value his services provided.

"He knows that we're on call whenever he needs us," said Kuebler. "We know his situation, and we make it a policy that we get back to him within 24 business hours. …Even if I haven't done any work for him in two months, he knows that the next time we meet, I'm keeping up with what's going on in his situation and I can keep steering him in the right direction."

Berg admitted that, during his AUM days early in his career, he felt guilty of providing little value after the initial engagement. "I found myself creating work, just to feel like I could justify my fee," he said. "So much of the work, and the perceived value, is on the front-end. With hourly, we have not found that to be an issue. They are initiating the call."

By Mandy Iahn and Connie Stone

The future of AUM

Advisors could benefit from rethinking fees

Over the past 50 years, "financial planning" has matured from stock and insurance sales to comprehensive services with increasing numbers of CFP® practitioners managing all aspects of their clients' financial lives. Advisors now take a predominantly holistic approach when setting goals, constructing plans, and implementing solutions. As the complexity of financial planning has expanded, fee structures have multiplied as well, often confounding consumers.

When advisors previously focused primarily on investment advice, it made sense to charge based on assets under management. However, fee models now need to adjust to reflect the comprehensive approach. AUM is under attack, and according to financial writer and commentator Bob Veres, an increasing number of planners and their clients are leaving AUM behind.

Benefits to using an alternative compensation model

Here are some ways in which changing the fee structure could benefit both the advisor and their clients.

Advisors will be fairly compensated for their work. Charging AUM implies that the compensation is based on investment advice when, in fact, the fee should be calculated based on the full range of services provided by an RIA, including insurance review, estate planning, and tax preparation and planning. "Charging our clients for the comprehensive nature of the work we do allows them to make the connection between what we do and how we are paid," said NAPFA-Registered Financial Advisor John Einberger, CFP®, president of the board of directors for the Alliance of Comprehensive Planners.

Advisors' fees will be independent of the advice they give. AUM poses an inherent conflict of interest. For example, a client might want to pursue a course with their finances that could diminish their AUM, such as taking a significant portion of their assets from under management for a non-investment purpose. In this situation, if they are billed based on AUM, even the best-intentioned advisor could instinctively and unknowingly resist such an approach.

Advisors can expand their clientele. Advisors charging AUM often require high investable-asset minimums. Using an alternative compensation model, advisors could expand the range of clients they serve instead of competing for high-net-worth investors. There are far more Americans with less than $1 million in investable assets in need of financial planning than wealthy Americans, and planners could help more people while still making a substantial living.

"Our retainer system allows me to service a virtually untapped market of young professionals," NAPFA-Registered Financial Advisor and ACP member Jake Kuebler said. "I can profitably provide planning when they need it most, such as when starting a family, and have their fee grow as their financial and life situations grow in complexity over time."

Advisors will not be left in the dust. The emerging trend to use "robo-advisors" at a fraction of the cost of using human advisors is stealing clients away. The Aite Group predicts that computer-calculated investment portfolios will more than triple by the end of 2015. What was a $16-billion industry at the beginning of 2014 will grow to as much as $60 billion. Financial advisors need to distinguish themselves from robo-advisors in order to compete, and using a different model of compensation just might set them apart.

Weighing the pros and cons

Fee-Only advisors have the option of charging fees in a number of ways, including AUM, hourly, or retainer. If charging an hourly fee, they could distinguish themselves from the robo-advisors, be compensated for all aspects of planning that they provide, and offer help to a wide range of people who need their services.

However, there are two main drawbacks to charging on an hourly basis. First, clients who are billed hourly often watch the clock instead of contacting their planner when they should because they don't want to incur additional charges. And planners who don't know the full story can't give holistic advice in concert with the client's total financial picture. Second, hourly fees encourage transactional rather than enduring relationships—clients work with their advisor for five, 10, or 20 hours, and then they are gone.

On the other hand, a retainer-based compensation model could lead to ongoing, long-term relationships. Under a retainer model, clients sign up for one or two years of services, and during that time the advisor can truly come to understand their needs and goals, watch how their advice effects their clients' lives, and establish bonds of mutual trust and respect. In addition, clients do not have to worry about contacting the planner for so-called inconsequential matters that often make a big difference, because an annual retainer has no time constrictions—planners are more likely to have all the information they need to develop the most strategic financial plan.

Compensation models are becoming more diverse, and it's in the best interests of advisors to investigate the models that will best serve their clients' needs, lead to new prospects, and perhaps engender a sense of gratification.

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