Silly Questions

Purists may swear off commissions, but that doesn't mean they'll be justly rewarded

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Illustrations by Boris Kulikov

WHAT DO YOU THINK is the most important question facing advisers this year? Is it steering clients through a swooning market? Or is it preparing them for that recession peeking over the horizon? Neither. According to trusted industry watchdog Bob Veres, it's the question—once again—of converting to fees. That's what he declares in his column "Fees or Bust" in the December 2000 issue of *Inside Information,* a newsletter for serious financial advisers.

Call me silly, but I still see the fee-only issue as a red herring. I've known Bob for a long time and I respect his opinions, but we'll have to part company on this one. Why should it make that much difference to a client how an adviser gets paid? In the rush to be redeemed, many planners have converted to fees mostly to distinguish themselves from commission-based brokers. But that won't work for long. Within five years most brokers will be fee-only, too. Then what will advisers do? Isn't the real question whose side you're on? However the broker gets paid, he'll always have the company's interests at heart. Clients are wising up about that distinction; they want their advisers to be looking out for them. "The method of compensation is not what puts you and the client on the same side of the table," says Cynthia Meyers, an adviser in Sacramento. "It's your orientation and your commitment to helping the client design the life of his choice." Meyers charges an annual fee for preparing and reviewing a client's annual financial plan, with an hourly fee for additional work. She uses load funds, mostly from the American Funds Group and Franklin Templeton Investments, for investment work because she believes they're cheaper than asset-based fees for her clients, who are long-term investors. Although Meyers realizes the tide is going against her on commissions, she is sticking to her guns.

Others haven't. They've been lining up to take the fee-only pledge, thanks in part to the financial press, which, as I discussed in this column last year, has largely succeeded in depicting commissions and fees as incompatible. In England such segregation is seen as unnecessary. A more balanced view prevails there, one that integrates fees and commissions into a fee-based practice. I like the more relaxed British approach. Either you trust your adviser or you don't.

I expected to get the raspberry for that column, particularly from the National Association of Personal Financial Advisors (NAPFA), the small group of purists on this subject. We did get a handful of letters and e-mail. One of them was from Ross Levin, an adviser at Accredited Investors in Minneapolis. I said in the column that Accredited gave up insurance products to join NAPFA, which does not accept as members planners who take commissions. To some, the column seemed to imply that Accredited chose the cachet of NAPFA membership over the needs of clients, although that was certainly not my intention. Levin is one of my favorite advisers, and he has taken the time more than once to give me a nudge in the direction of exploring important issues. And as it turns out, Levin is not a NAPFA member at all—mea culpa. Both to set the record straight and to dig a little deeper into this issue, I called Levin to see why he *did* give up the insurance business.

Here's what he had to say. Four or five years ago both Levin and his partner, Wil Heupel, were licensed to sell insurance, although Heupel handled most of that work. One day the two were meeting with a large client who, they decided, needed a second-to-die policy. Heupel made the presentation. "We had a great relationship with the client," Levin says. "But even though buying the policy was the right choice, the client didn't want to do it, partly because we were getting paid a commission. It wasn't an issue of our integrity, but it was a question of our independence."

This marked a turning point for Levin and Heupel. "Wil said he didn't want to come in and be the insurance guy anymore and have it look like he wasn't on the same side of the table as the client," Levin says. So here we are back to whose side you're on.

Levin and Heupel didn't want to offer no-load or low-load products, because they don't think those products perform as well. Heupel says that's because over longer periods, low loads have more internal costs than an insurance-agent-sold product, eroding the performance. "I would guess the internal costs are higher for low load than commission based," Heupel says. (We'll hear from Don Reiser, of Ameritas Life Insurance Corp., on this one, no doubt.)

Today Accredited uses high-quality products like those offered by Northwestern Mutual. Heupel uses his insurance expertise to persuade the agent to restructure the policy so there is more term and less whole life, because term carries less commission.

Levin doesn't see compensation as a black-and-white issue. "Everyone makes this out as a huge right or wrong issue, like compensation is the equivalent of competence," Levin says. "That's not right. But it's easier to act on conflicts of interest if you're not getting paid on commission."

Whether Accredited sold the policy or someone else sold it doesn't make that much difference to the client's needs, Levin says. "The client is probably equally well served either way. But we felt better about it." I see Levin's point, and I understand why advisers give up insurance. But I still think the client might actually be better off if the planner controlled the insurance piece and got the commission, which could offset some of the client's fees. For instance, if Heupel sold the policy and Accredited collected the commission, the money would be "in the house," so to speak. If the client buys it from an outside agent, he still pays a commission. Heupel still has to do plenty of work on the policy. But he doesn't get any of the commission. I'm not picking on Levin and Heupel here, because I know most advisers agree with their thinking. But I don't get it. Why does it make better sense to let go of the client's money?

As it turns out, Levin isn't a purist on all fronts, and for that I applaud him. For example, he has an arrangement with a company called First Mercantile Trust Co. for small-company 401(k) plans he oversees for clients. For 12 of its clients, Accredited offers a portfolio mix of 19 investment choices with First Mercantile at a total fee of 1.3 percent of which 75 basis points is reallowed back to Accredited. This arrangement would not pass muster with NAPFA because the client

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does not pay the adviser directly. But Levin uses it because it's cheaper for clients than if Accredited were to use mutual funds and add its own management fee. I'd like to hear a fee-only advocate make the case for how it would be better for the client if Accredited used regular mutual funds and the client paid, say, 180 or 200 basis points.

The problem underlying all of this is the asset-based fee. Such a structure may make sense as a method of compensation for money management, but it doesn't work for financial planning. Furthermore, most advisers have certain categories of assets they don't charge for. For example, Levin doesn't include municipal bonds, low-basis stock, or the money a client has in his employer's 401(k) plan. "If it's just sitting there and we're not rendering advice against it, we don't feel we should charge against it," Levin says.

I suspect a lot of you do business more or less like Accredited Investors. You're on the client's side, and you charge fees roughly based on the client's asset pool. Maybe you don't want to charge insurance commissions, because you feel it's a conflict of interest or because you think it makes you look sleazy. And you probably toss a lot of stuff into the pot, like Levin's muni bonds, that you don't charge for.

To me, that looks more like a hodgepodge of charges than a professional fee structure. Worse yet, charging a fee that's a percentage of assets leads clients to focus on the investment performance of those assets. My accountant doesn't charge me based on how much I pay in taxes. Thank goodness.

So what fee structure would allow fair compensation without sullying anyone's image? The simple and straightforward answer is flat retainer fees. That's the way it works in my business. I can't imagine writing a column and having the editor say, "If the stock you write about goes up, we'll pay you a percentage of the returns." If an adviser charged a flat retainer fee, the commission issue would disappear. Suppose you charge me a flat fee, and then you propose an insurance policy. If the commission comes from the fee I'm already paying you, why should I object? I'm paying you the same amount whether I buy the policy or not. Overall, I might actually be paying you less. You're on my side. You're taking an objective view. You have no conflict of interest. Or what if you want to use a load mutual fund? No problem. Such a fee structure allows you to pick from a full range of products. I already know how much it's going to cost. And I know whom you're working for. So where's the flaw?

The purists are sure to give me some serious answers.

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