LET'S TALK ABOUT FEES

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Imagine the following conversation:

Doctor: Mary, I think that you need physical therapy for that pain in your shoulder. I'll go ahead and set up an appointment for you at ABC Therapy.

Mary: But Doctor, my shoulder is getting better on its own. Why do you think I need physical therapy and why do you recommend ABC Therapy?

Doctor: Because ABC Therapy gives me 10% of any fees that they charge my patients. Also, I would like you to start taking this drug, PressureBeGone, for your high blood pressure.

Mary: But Doctor, isn't that the expensive new drug I see advertised on TV? The cheap generic that I am taking now is working just fine.

Doctor: Mary, I have a car payment to make. Didn't you see my Tesla out front? The drug company pays me a nice kickback when I prescribe PressureBeGone to my patients. Now, let's talk about the surgery to remove your gall bladder. I'll schedule the operation with Dr. Nogall for next week.

Mary: Excuse me, doctor. I didn't know that I had a gall bladder problem, much less that it needed to be removed. Tell me more.

Doctor: Did you forget already? One word: Tesla. I need to make that next payment and Dr. Nogall gives me a nice referral fee for anyone I send to him. He's very expensive, but your insurance should cover it.

Mary: I'm sorry doctor, but I don't feel good about all this. It sounds like you are making these medical recommendations, not because they are good for me, but because you will profit from them.

Doctor: Mary, please! I'm a professional. Your health and welfare are of utmost importance. You need to trust me. I can't help you if you don't trust me and take my recommendations. Are we clear on that?

Mary: I guess.

Doctor: Good. I think we are done for today. Let me show you my Tesla. It’s right out front.

Improbable conversation? Sure. But do some doctors profit from their recommendations? Some do.

But this isn’t about doctors. It’s about financial advisors.

How are financial advisors compensated for their services? There are several ways.

Commissions: Many are compensated by charging commissions. If you buy a stock that the advisor recommends, she would get a commission from that sale. Or if she sells you a whole life insurance policy, or an annuity, she would get quite a hefty commission.

The weakness in this model is clear. The advisor is motivated to sell you stocks (and churn your account), as well as to sell you annuities and whole life insurance policies, even if these are things are not in your long term financial interest. (Remember the Wells Fargo scandals of 2016? And 2017?)

AUM - Assets Under Management: Under this arrangement, the advisor is paid a percentage (typically one percent or so) of the assets under his management. This creates a situation in which the fees charged bear little relationship to the services provided. In addition, the advisor is motivated to advise the client to fully fund the investments under the advisor’s management, even if a different course of action, such as funding a 401K at work or paying down a mortgage, is more in the client’s interest. But it’s a very popular model for advisors because the customer doesn’t see the money being charged to the account (lack of transparency) and, accordingly, doesn’t complain.

Rewards: Each year I go to the AICPA Financial Planning Conference in Las Vegas. It’s a very intensive 3 days with great sessions and speakers, among the best in the business. My favorite sessions are those that deal with behavioral finance (why people do what they do with their money and how to get them to stop doing bad things with their money). But one session I attended was on marketing. It was a small enough group that I decided to ask a question. Here's how the conversation went:

Me: "How do I explain the difference between a financial advisor who works for a bank or brokerage firm and a true long term comprehensive financial life planner like me who works for the client and is guided by the fiduciary standard. I want to be able to explain this without coming off as a mean-spirited jerk who is trash talking the competition."

Speaker: (Laughs.) A few years ago I was on a cruise ship. I noticed that a lot of the passengers were from the same brokerage firm, the one with the store fronts and green awnings. I asked why so many people from the same firm were on the cruise. He responded that they had met specific sales quotas and that this cruise was their reward for having sold a lot of products to their clients. But then he added, 'the people who met the highest sales quotas are on an all expense paid trip to Italy!'"

He went on to answer my question directly. Google the name of the brokerage firm, he advised, and look for articles about how the salespeople are compensated. Use words like "sales quotas" and "sales rewards." In other words, let the internet do the trash talking.

Fixed Fee: Many advisors, especially true long term comprehensive financial life planners, charge a fixed fee and nothing else. For example, the planner might charge $5,000 to create and implement a long term comprehensive financial life plan and then charge $500 per quarter to maintain the plan and help the client to stick to the plan.

Note that this eliminates the conflict of interest inherent in the other models. The planner is motivated to help the client choose the best investments that are both low cost and consistent with the plan rather than choose the investments that provide the greatest income to the planner (and to the executives and shareholders of the bank or brokerage firm). If the planner earns enough money to go to Italy, it will be because she provided a valuable service to her clients, not because she met certain sales quotas.

Another advantage is that the planner is paid from funds outside the retirement accounts. The AUM model, on the other hand, pulls money out of the retirement accounts, thereby reducing those tax-favored investments.

But even more importantly, a true long term comprehensive financial life planner provides valuable services that go way beyond choosing investments. But rather than go into detail on those benefits here, I recommend that you read some of the other articles that I have written, especially the following: