SWITCHING FROM COMMISSIONS TO FEES

Commission-based advisors earn their income solely from selling products or opening accounts, meaning these advisors earn more if they sell more. In contrast, fee-based advisors earn their income from the pre-stated fee they receive for their services – the fee can be a flat fee or an hourly fee.

What happens when an advisor's income is only based on commissions? The advisor isn't always focused on what's best for their client. Although a fee-based model isn't perfect, there are more advantages for both the advisor and the client than with commissions. In just three years, the amount of fee-based accounts has increased from 21% to 28%, and within the retail wealth management industry in North America, 91% of advisors have at least one fee-based account.

More advisors are switching to fees over commissions, but don't blindly switch to fees because everyone else is doing it, know the advantages and disadvantages of a fee-based practice!

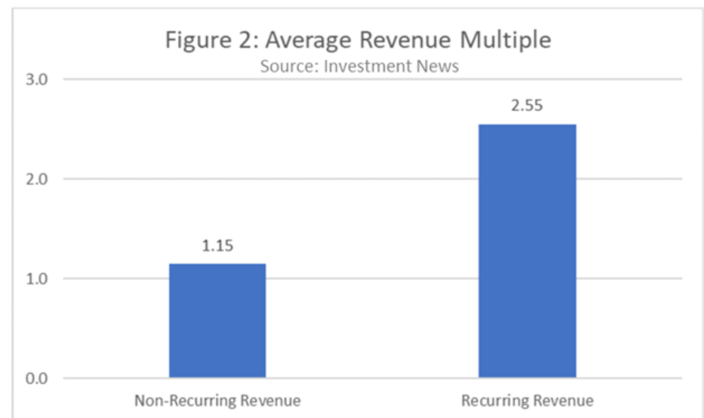
Advantages of a Fee-Based Practice

There are four key advantages to switching to a fee-based practice:

1. Increase in the valuation of your business

According to a study done by PriceMetrix, advisors that transitioned more of their book to fee-based had larger growth in their assets, compared to advisors that have a lower fee-based ratio, between 2009 and 2012. The advisors that had a 25% or more increase in their fee-based ratio saw a 49% increase in their assets during the three-year period (see Figure 1). The other two groups that still increased their fee-based ratio — but slower than group 1, still saw an increase in their assets over the three years.

Not only are fee-based business growing faster, they have a higher overall value. Based on an article in Investment News, an easy approach to finding the valuation of a company is by using multiples of recurring and nonrecurring revenues. For recurring revenues (i.e. fees) an average multiple of 2.55 is used, but for nonrecurring revenues (i.e. commissions) an average multiple of 1.15 is used (see Figure 2).



2. More focus on client relationship — work on the same side as the client

What's a large perk of a fee-based practice? You don't have to go to work with the mindset of HAVING to sell in order to make money. If you joined the field because you love helping people, then a fee-based practice is the best option for you.

Fee-based accounts are held to a fiduciary standard of care. This means they are legally required to do what's best for their client. Clients have more trust for their advisor when they know their best interest is in mind, not just getting the most money out of them. Being a fiduciary means not being able to sell a client investment products that are against their needs, objectives, and risk tolerance (Investopedia).

3. More consistent revenue

According to the study by PriceMetrix, a commission-based account has an average RoA of 0.54% while a fee -based account has an average RoA of 1.18% (see Figure 3). Yes, a commissions-based practice comes with larger up-front revenue; however, a fee-based practice gets more revenue over time (and is more consistent.) Figure 3 also shows fee-based accounts have higher average account assets and average account revenue.

Looking at the table, the average account revenue for a fee-based account is more than 3 times higher than the average transactional account.

Figure 3: Fee Accounts vs Transactional Accounts
Source: PriceMetrix

	Fee Accounts	Transactional Accounts
Average Account RoA	1.18%	0.54%
Average Account Assets	$256,400	$175,200
Average Account Revenue	$2,900	$870

4. Alleviates future regulatory issues

A key difference between a fee-based practice and a commission-based practice is fee-based advisors have a fiduciary duty to their clients and commission-based advisors aren't required to. This means fee-based advisors legally have to put their client's best interest first. The main issue with commissions is the advisors get rewarded for having their client engage in active trading or using higher cost products, regardless of whether this is in the best interest for the client.

Churning is another potential issue with commission-based practices. This unethical practice is when the advisor overly buys and sells securities in their client's account or moving investments to higher paying products. Churning helps the advisor receive more from their client without necessarily helping their client. Since fee-based advisors are obligated to best serve their client, there are less regulatory issues to be faced in the future; however, reverse churning is beginning to be something regulators are focused on as well.

Reverse churning is putting a client's accounts in a commission-based product just so the advisor can collect revenue. In these situations, the client pays the fees, but receive little advice, trading, or account activity (Lew).

There are a lot of positives that come with a fee-based practice; however, there are still a couple of negatives you should be aware of before switching.

Disadvantages of a Fee-Based Practice

There are two key disadvantages of a fee-based practice:

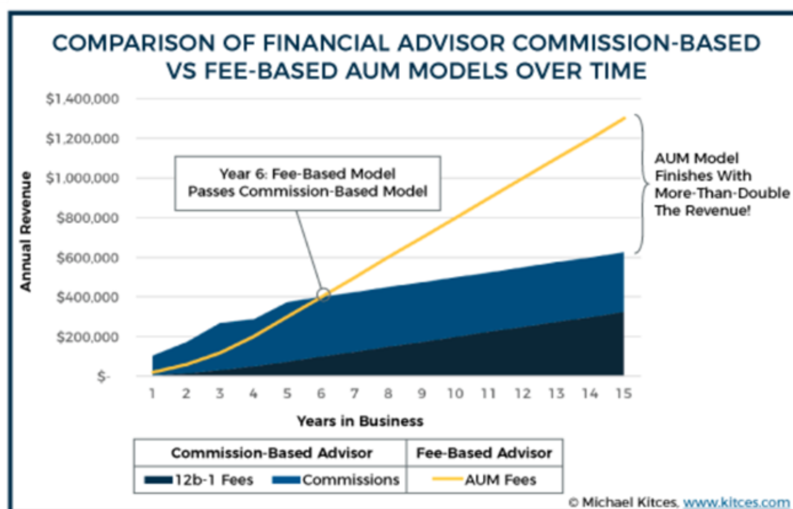
1. Interruption of cashflow

Initially switching to a fee-based practice is difficult. The first five years after switching to fees, the advisor will most likely make less than when using commissions, by year six they are equal, and beyond that the fees are often above commissions.

Again, in a commissions-based practice the advisor receives large upfront revenue; therefore, an advisor switching to fees will see a loss in cashflow initially. A Kitces Report explains that a commission-based advisor averages 5% in commissions during the first year, but drops to 4% in year 2, and drops to 3% by year 4. A fee-based advisor usually receives a steady 1% AUM fee.

The chart to the right (Figure 4) shows the equal point between the two models at year 6, by year 10 the fee-based advisor is making 50% more, and by year 15 the fee-based advisor has more than doubled the revenue.

Figure 4



Taking the initial loss after the switch can lead to large gains in the future! Being prepared for the initial lower revenue will help make the shift smoother.

2. A fee-based practice is more service-intensive

Since the clients are paying set fees for services and advice, their standards are higher than with a commissions-based advisor. To meet their expectations, extra staffing or time spent in furthering your education might be required. Brian J. Carney, CFP, stated the need for more skilled, educated professionals who are able to manage their clients' requests and hold them accountable to their goals and financial plans is important for any financial professional looking to switch to a fee-based practice.

Once established, a fee-based practice can be more repetitive and take the reliance off being a good sales person and placing the focus on being a good financial advisor.

Overcoming the Disadvantages Through Outsourcing

Don't let these disadvantages stop you from switching to a fee-based practice. Although a fee-based business is more service-intensive than a commissions-based business, it allows the advisor to build an actual business instead of one that relies solely on the advisor's ability to sell. Everything isn't put on the advisor in a fee-based business. These advisors have the custodian, investment manager, and/or other business partners for support. This allows the fee-based practice to systematize everything from account opening, maintenance, client reviews, portfolio allocations, and investment management.

Fee Transition Checklist

1. Define where you want your business to be in 5 years—Who are your clients, what is your value proposition for those clients, where is the industry heading?
2. Go through your entire book of business, listing the assets, fees, location, and payment schedule for each client.
3. Talk to your compliance officer about what accounts cannot be transitioned from commissions to fees.
4. Create a cash flow budget for the next 3 years to determine the speed at which you can transition clients from commissions to fees.
5. Develop a strategy to contact your clients with your new business strategy.
6. Create a tracking method to monitor your progress
7. Schedule a quarterly review of your progress, adjusting your plans as appropriate, but keeping the vision identified in step 1 as the focus.

About the Author

Courtney Hybiak is a senior at the University of Arizona. She is majoring in Business Administration (Marketing emphasis) with a minor in Psychology and has been on the Dean's List with Distinction multiple times. Courtney was involved with Future Business Leader's of America throughout high school and qualified for the national competition twice, finishing 6th her senior year in the Business Financial Plan category.

About SEM Wealth Management

SEM Wealth Management is an SEC-Registered Investment Advisor founded in 1992. SEM serves as the Outsourced Chief Investment Officer (OCIO) for financial advisors across the country, utilizing a platform designed to make the financial advisor more efficient. SEM helps these advisors systematize their business by setting up risk tolerance screening processes, model portfolios, operational support, and marketing assistance.

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