Focus

The Future of Fees

by Nancy Opiela

What is a fair fee for the myriad services you provide for your clients? Or, for that matter, how do you establish and define your fee? While financial planners' fees once were calculated simply as a percentage of assets under management, compensation has evolved to encompass a number of different models. In addition to assets under management, planners use retainers or charge on an hourly basis—and some employ multiple compensation models and allow clients to choose the method of payment they prefer. In fact, it's difficult to think of another profession where the consumer pays in so many different ways for services. And, in speaking with planners about their fees—how they establish them and how they explain them to clients—it's clear that financial planning may never have a one-size-fits-all compensation model.

Will Retainers Reign?

Years ago, in presentations at various industry conferences about the future of financial planning, Roy Diliberto, CFP®, CLU, ChFC, often would speak about the wisdom of switching from charging a percentage of assets under management to retainer fees. Inevitably, someone in the audience would ask, "Roy, when did you switch to retainers?" After several years of responding, "I plan to—in the future," Diliberto, tired of the exchange, took the plunge in 2000 and converted approximately one-third of his practice from assets under management to retainers.

Today, after some retainer evolution, RTD Financial Advisors Inc. (Diliberto's firm with offices in Philadelphia, Pennsylvania, and Bonita Springs, Florida), charges all new clients one flat fee, broken out quarterly. The retainer covers all services provided, including asset management, but is independent of the amount of assets the firm manages for the client.

"If your net worth is under a certain amount, there's one flat fee, and for each additional $500,000 there is an additional amount added to the flat fee," he explains. "The flat retainer fee is set for three years. Whether the client inherits $5 million next week or withdraws $1 million from the account, the fee doesn't change. At end of each three-year period, we re-negotiate. In fact, several retainers have come up for review recently where we've increased the fee, and I haven't had any negative reaction from clients."

In fact, Diliberto says new and older clients alike have embraced the change, largely because the model avoids all potential for conflicts of interest. Diliberto explains what he sees as the primary benefit of retainers to clients this way: "Let's say we manage your $1 million portfolio and charge you 1 percent as our fee. Then one day, you call and ask me whether you should invest $500,000 in your brother-in-law's business. I can come up with one of two answers—I can tell you it's not a very good idea, in which case you might wonder if I said no simply because it would cost me $5,000 to say yes. Even though my advice might be good advice, you would be suspicious of my motives. The second option is that I could say, 'Yes, it's a good idea. Go ahead and invest.' But that advice has just cost me $5,000 and that's not a good situation for the long-term relationship either."

Continues Diliberto, "Over the years, I've found clients are very sensitive to any perception of conflict of interest. I remember one man who was interviewing many planners. After our initial meeting where I described how we could help him, he called me every ten days or so to tell me he was still looking, but that we were still number one on his list. One day he had a pension question. He and his wife were in their early sixties and they had the option to take 7 percent of the value of the portfolio every year as long as either of them lived. Coincidentally, that was the amount they needed for fixed expenses, so the rest of their portfolio could grow forever. He had accepted the offer and I looked at it quickly and told him I thought he'd made a pretty good decision.

"The next time he called, he said his wife had been up all night because they'd gone to interview another advisor who told them they should have taken a lump sum. I said, 'I still think you made the right decision,' and he responded, 'I suspected as much. After all, that planner gets paid on a percentage of the assets he manages.' We don't know whether that advisor's recommendation was influenced by the money he would make. But even if we assume that he really thought it was good idea to take the lump sum, that doesn't

change the client's perception that there was a conflict of interest and that he was not getting good advice for his money. In matters of trust, the client's perception is all that matters."

Another way retainers can help avoid stresses in a client relationship is by separating a planner's performance from the market's performance. Diliberto often shares the following what-if scenario that resonates with his retainer clients: "Let's assume all your money is invested in equities and the stock market is up by 28 percent and your portfolio grows by 28 percent. What did our firm do to cause that to happen? Most clients will answer, 'Nothing.' And I say, 'Exactly. So, really, why should you give me a raise in a bull market?' Now, let's look at the other side. What if the market declines 20 percent and your portfolio declines 20 percent? If I have nothing to do with the gains, I certainly have nothing to do with the losses."

Retainers: Trend or Hype?

Although there has been a lot of talk at industry conferences about retainers, D. Christopher Brown, CFP®, managing principal of Brown Research LLC in Exeter, New Hampshire, and author of "Alternative Practice Benchmarks" (working title), a Financial Planning Association study produced by the Financial Research Corporation (FRC), has not found any evidence of a transition from assets under management to retainers in his recent research that compared feedback from 821 FPA members in 2005 with data collected in 2003.

"While not conclusive from a statistical standpoint, what we found was surprising from a directional perspective," he explains. "The sample of RIAs [registered investment advisers who use retainer fees] in 2003 derived, on average, 34 percent of their revenues from retainer fees. The sample in 2005, however, booked only 27 percent of their revenues in this form. Because the samples in both cases contain approximately 200 RIAs charging retainer fees, we cannot assert with confidence that this finding refutes the claim that RIAs are moving away from asset-based fees toward retainer fees."

Brown notes that the movement to retainers is not as great as the attention given to the model in the press because it doesn't work for all practices. He asserts that a large practice, high net worth clients, and long-term relationships are essential in order for a planner to successfully shift to retainers. "The longer you are in business, the better you become, and the profile of your average client moves more toward higher net worth," he explains. "What's more, over the course of a relationship, the client builds wealth and has concrete proof of the value you as an advisor have brought to his life. Those clients may be willing to write a big check, but new clients who may not have the faith that it's all going to work out fine for them 20 years from now may be reluctant to pay that way."

In fact, Brown says a client probably should have $1 million or more in investable assets before a retainer would make sense. "To generate annual revenues of $1 million from retainer fees alone, a firm would need to have a minimum of 100 clients being charged $10,000 each. These charges would need to continue year after yearÑand that would require an extensive range of services to support that level of fee," he notes.

That said, however, Brown does think it's feasible for any advisor who charges a separate planning fee to move at least that part of the business to a retainer. "Perhaps you charge clients something for the initial comprehensive financial plan and then, as you do ongoing reviews, you charge them an additional amount each year," he suggests. "That's diversifying the revenue stream for the practice, although the primary revenue stream is still from asset-based fees. We found that 70 percent of revenues came from asset-based fees, so the business risk would be too great to change your compensation model overnight."

Although Diliberto acknowledges that his established practice facilitated his transition to retainer, he sees plenty of potential for planners working with clients without high net worths to use this model. He explains, "There are many high-earning people who have the money to pay your fees and will be a valuable client in the long term, but have no assets to manage at the moment. If a person like this comes into your office and you adhere strictly to an assets-under-management model with a high minimum, you have no way to work with them. If that's the case, how are you building your practice? What's more, how are we to grow as a profession?"

Diliberto also stresses that whatever the size of a retainer-based practice, the model brings financial

planning to the forefront of the relationship. "Planners complain all the time that clients think they are nothing more than investment managers, when they really provide so much more. I'd ask a group of planners, 'How do you get paid?'—and if the response is assets under management, then my question is, 'Then what do you expect your clients to think?' Similar to what Emerson said, 'What you do speaks so loudly, I can't hear what you say you are.'[1] Planners need to remember that actions speak louder than words and that maybe we need to re-focus our clients on what really matters, what they are really paying for.

"For clients, the end is not the performance of the portfolio. The end is living the life they want to live."

On the Clock, Across the Board

While retainers may or may not be more appropriate for high net worth clients with plenty of investable assets and issues, hourly fees may be more appealing to consumers with less complex financial situations. Rather than pay a steep fee for comprehensive services, hourly fees make it possible for a planner to concentrate on a discrete issue or two. But as different as they seem, the roots of the models are the same—planners have to figure out what an hour of their time is worth.

What Bonnie A. Hughes, CFP®, of A&H Financial Planning & Education Inc. in Chattanooga, Tennessee, likes most about charging by the hour for financial planning is the flexibility and control it affords her clients. "Whether I work on a college savings plan or comprehensive financial plan, it's the same hourly rate," she explains. "Clients can control the time I spend. If they do a lot of calling and I find myself doing a lot of babysitting, they know they will be looking at a higher fee."

She says clients also appreciate the transparency of the model. "I state my hourly rate and then I talk in hours," she says. "A typical financial plan that includes most of what we want to cover is going to run 12 to 20 hours. I can defend my hourly rate very easily, and I can defend the work that I do by the hour, and clients appreciate that."

Hughes asks for a deposit of $500 or half of the project amount, whichever is less, and clients pay the balance when the work is done.

Just this year, she began offering asset management services on an hourly basis. "I'm tracking how much time I'm spending on each account and so far it's working out to a maximum of 50 basis points. Tracking time is a little trickier than financial planning and I need to make sure it works out for me in the end, but so far, so good," she reports.

Hughes notes that because many prospective clients visit her Web site, which outlines her hourly approach to planning, before coming in for a meeting, most already have the "basic idea behind what I do and like the hourly approach."

In addition to working well for clients, she says charging hourly has a number of benefits for the planner. First, her model allows her to work with a demographic she enjoys: do-it-yourselfers, young people without a lot of investable assets and older people in the distribution phase of their portfolio. Also, she says an hourly fee structure lets her dabble in areas of interest. "That's very important for a planner who easily gets bored," she says. "For instance, I do some work for a CEO who is worth $15 million. He does his own investing through Fidelity and does just fine. He's interested in funding a charity overseas and came to see me when he felt his estate planning attorney was just not hearing him. He hired me on an hourly basis to work out some of the financials and to sit in the meetings with them and communicate what it is he wants."

Assets Under Management Remains Popular

Robert Wander, CFP®, of Wander Financial Services in New York, New York, embraces the assets-under-management model because he doesn't want his clients to feel like the "meter is running" as they might if he charged hourly. He says retainer fees are more difficult to justify and price correctly and, "in any given year, there's no telling what value the client will get for it."

"The assets-under-management model is transparent and it doesn't require the client to do anything once it is agreed to and set up," he explains. "We both benefit if assets grow and feel the pain if assets decline."

Wander notes, however, that he sets his percentage to take into account whatever additional services are to be provided to the client. "When I present the pay structure, I describe all the other services the client will be receiving."

He also believes this model is designed for a long-term relationship. "My financial success is dependent upon maintaining the assets over many years, which requires a happy client," Wander says. "You want your client to call on a regular basis, even if it's about a small issue. That contact is what builds the relationship. Someone who is paying hourly might be less inclined to pick up the phone and ask a question if they figured they'd be paying for the answer. I tell clients I prefer that we both sit on the same side of the table. In a down market, there's something to be said for my fortunes being affected, too. Having their account down 10 percent but seeing the planner doing just fine is difficult for clients to stomach."

A Little of This, a Little of That

Robert Mecca, CFP®, of Robert A. Mecca & Associates LLC, in Mount Prospect, Illinois, charges his clients one of three ways: a flat fee, an hourly fee, or a percentage of assets under management. "It all depends on what is most economical for the client. I present the alternatives and they choose. For example, if a client wants me to plan for college or help with the transition of a business, I'll give them an estimate of hours involved, my hourly rate, and they can choose to pay be the hour or I'll charge them a flat fee."

His approach has been successful, he says, because people like choices. A range of payment methods also enables him to serve a segment of the market often overlooked by financial planners. "We have no net-worth minimums," Mecca says. "Some planners want to put all of their time into the big fish and that's okay. I'll take the smaller fish, provided it's still profitable for me. Over the years, we have found a couple of things: first, the small fish are profitable and second, small fish know big fish. There are people who come to me and like what we do, and bring me other members of their family, or their doctor who is a successful professional. Also, small fish grow up to be big fish, or they inherit money and remember we handled their finances when they were small.

Stewart S. Koesten, CFP®, CFS, of Koesten Hirschmann & Crabtree Inc. in Overland Park, Kansas, also offers a number of payment methods. "We are first and foremost a financial planning firm, and our fees are structured to allow us to work with everyone from high net worth clients with a broad range of issues to those with just an issue or two, such as funding college education or buying a vacation home."

For these simple engagements, Koesten charges on an hourly basis. "We try to be reasonable and always give a price range," he says. "Alternatively, the client can work with us on a comprehensive wealth management basis where we act as their chief financial officer and charge an annual fee, a percentage of their net worth, to provide a canopy of financial services. We also offer investment management services that include a certain amount of financial planning, and that fee is a percentage of assets under management."

While Koesten acknowledges that comprehensive wealth management clients are the firm's ideal, he says he pays a lot of attention to high earners who currently don't have a lot to invest, but will eventually become the firm's ideal client. "Our different fee structures allow us to pursue both types of clients and offer services the way each is comfortable paying for them," he says. "Sometimes it's obvious what fee structure is the best for the client. Other times it requires a discussion, and sometimes we're a ways into the process before we understand what the client prefers."

Looking Ahead

D. Christopher Brown notes that while assets under management is still the most popular compensation model, he was impressed during his interviews with planners for the FPA study just how passionately some made the case for retainers or hourly fees. That's no different with the planners interviewed for this story, who report that they are starting to see their particular passions reflected in the profession.

Says Roy Diliberto, "Since about 2002, a change has begun to occur. I'm in a national study group and more often than not, those planners are using retainer flat fees. Even some who argued with me about my

own transition are now asking me more questions and seem ready to put their toes in the water. Reaction to my transition to retainers used to be, 'What are you—nuts?' Now it's 'Do you have five minutes to talk about how retainers are working for you?' Today, most consumers don't even know that the flat fee choice exists. But if given the chance, they will embrace it. I've converted every client I've talked to."

Diliberto's bottom line? "If we are to become a true profession, we'd better start treating ourselves like professionals. It's ironic that financial planning is our real work yet that whether assets go up or down is the basis for our compensation."

He adds that charging a one-time fee for a financial plan relegates the plan to product status. "Planning is a process," he insists. "Rather than throwing in a financial plan for free, we should establish the need to charge for planning on an ongoing basis."

Bonnie Hughes expects a movement in the industry toward the hourly fee, largely due to its transparency, but it will be a glacial one. She explains, "I had lunch with four Raymond James folks last week about the way I charge. I think there is a lot of interest in hourly fees, although planners are terrified of the initially lower income that they will most likely see."

She adds, "The industry as a whole, with mutual funds disclosing fees and expenses, is moving toward greater transparency, so it makes sense that the financial planning profession should follow. With hourly fees, people who are not familiar with financial planning can understand and appreciate what they are paying for."

If there's a period of transition, Chris Brown expects to see many hybrid approaches to fees. "Maybe a planner's goal will be to have only half of the practice based on asset-based fees. In that case, the planner might move from charging 100 basis points to 80 or 75 and implement an additional planning fee to offset the decrease. Another planner might charge a flat retainer fee for the first year and then charge based on assets under management after that," he says.

As compensation models continue to evolve and increase in variety, it will be increasingly important for planners to communicate their fee structure to clients and quantify for clients the value they are receiving for the dollars spent. Of course, that's no small challenge when the true value derived from the relationship will most likely be understood only years down the road. To help planners establish the necessary trust to help clients make that leap of faith, Roy Diliberto has some closing advice offered to him by a client as he broached the subject of raising her retainer fee. "When you're talking about your fees, smile."

Endnote

1. Ralph Waldo Emerson (1803–1882): "What you do speaks so loud that I cannot hear what you say."

Nancy Opiela, based in Medfield, Massachusetts, is a contributing writer for the Journal of Financial Planning.

Sidebar

How Do Planners Charge Clients?

Josh Itzoe, Greenspring Wealth Management Inc., Towson, Maryland: We use a combination of flat fees and assets under management. Clients who hire us to develop a comprehensive financial plan are charged a flat fee for the engagement based on the level of time, effort, and expertise required to complete the plan. Once complete, clients may implement the plan themselves or hire us, for which we charge a percentage of assets under management. The client is billed separately for each service and we do not provide discounts or rebates for planning clients who subsequently hire us for investment management.

Edward Mora, CFP®, CRC, ChFC, Union Bank of California, Irvine, California: We charge on a project basis. In other words, based on the scope of the engagement, we estimate the number of hours and who will be involved in the plan. We then use internal billing rates to arrive at an engagement fee.

Keith Newcomb, AIF, Full Life Financial LLC, Nashville, Tennessee: Our fee structure is a percentage of assets for asset management (including management and all time and communications directly related to management), and an hourly rate for financial planning, special services, and anything else that is not asset management or related communications. We have found that this fairly and clearly separates the value of planning from the value of asset management.

Kevin O'Brien, Creative Financial Strategies Inc., Littleton, New Hampshire: We charge a flat fee for financial planning efforts ranging from $1,500 to $4,200 for the first 12 months based on client net worth and complexity of planning needs. Further, we charge an asset-based fee for investment management. Fees are tiered from 1.5 percent to under 1 percent, based on breakpoints.

Matthew Tuttle, CFP®, Tuttle Wealth Management LLC, Stamford, Connecticut: We use assets under management, but only because it is what people are used to and comfortable with. I would like to eventually go to a retainer fee structure based on net worth because it more accurately reflects the work we do and the value we provide. At this point, however, I am afraid to mess with what works.

Cynthia Zalewsky, CFP®, CSC, Saratoga Investment Solutions Inc., Saratoga Springs, New York: I use hourly consulting fees for my ongoing consulting clients, initial financial plan fees, and project fees. I implemented this by request from my existing clients about five years ago as an affordable way for me to service their friends and family who did not need or could not afford comprehensive wealth management services. I use an annual retainer for my wealth management clients. We revisit the retainer annually to ensure it is still appropriate for the level of service they require.

How Planners Present Their Fee Structure to Clients

Norman Boone, CFP®, Mosaic Financial Partners Inc., San Francisco, California: We disclose and discuss our fees as openly as possible. Our initial marketing information includes full, detailed descriptions of our fees. Our Web site does the same. Our initial meetings review the fees. We present the client with an engagement proposal and describe the fees as well. Our letters of agreement all fully describe our fee arrangement. Ultimately, if we are a good fit for someone, the fees are never an issue. Part of that is because it is clear to everyone from the beginning what the costs will be.

Carol Fishburn, CFP®, Brentwood Advisory Group LLC, Los Angeles, California: I offer three fee structures: hourly, assets under management, or retainer. I wait until the end of my initial meeting with the client in order to have formed an initial impression of what I think is the best fee structure for both of us. I start by telling them that I have the above three ways, but make a recommendation of the one I feel is best suited.

Josh Itzoe, Greenspring Wealth Management Inc., Towson, Maryland: We explain to clients that financial planning and investment management are two separate disciplines that serve different purposes and require distinct areas of expertise. Clients inherently understand this distinction although they are typically used to paying for investment management and receiving planning for free.

Stephen Madeyski, CFP®, Stephen Madeyski Financial Planning LLC, Albuquerque, New Mexico: I usually quote the client a fixed dollar amount or a range of hours that the work will take. This way the client knows what he or she will be spending and it is not like a situation with an attorney where the client is always concerned that every phone call will rack up minutes and thus extra costs. Then, after one year, we get together and usually negotiate a reduced number of hours for ongoing financial planning reviews.

Edward Mora, CFP®, CRC, ChFC, Union Bank of California, Irvine, California: ...We always prepare a letter of engagement (LOE) for prospects. This clearly outlines our philosophy, process, timeline, scope of planning, and fees for the engagement. By using an LOE, it places the fee in its proper context, and we have been very successful with this model. Lastly, we only require 50 percent of the fee up front, and the remaining 50 percent only upon complete satisfaction of the client."

Jennifer Noah, CFP®, CDFA, The Monitor Group Inc., Martinez, Georgia: Most of our clients want financial planning and investment management. For them we use a comprehensive contract, with a fixed

fee covering both services. We explain our comprehensive approach and belief that all aspects of their financial life work together to improve the likelihood of achieving their goals. The fee is quoted as a quarterly amount and billed quarterly. Clients may cancel with 30 days' notice but if we've prepared the plan, they are obligated for the first four quarterly payments. This is an open-ended contract thereafter, with the 30-day cancellation available to either party. We may increase the fee from time to time with notification to the client.

Don Whitton, CFP®, Mainstay Capital Management LLC, Grand Blanc, Michigan: I compare it to the seen and unseen fees and expenses they are paying in a commission-based environment, as well as the conflict of interest that is inherent in that approach. Our model purely aligns our interests with that of our clients, paying us directly for the service we provide and not being transaction-based.
From the 2006 FPA/FRC Advisor Study: Alternative Practice Benchmarks

Findings from the November 2005 Financial Research Corporation's (FRC) wide-ranging online survey with 821 practitioner members of the Financial Planning Association:

- Asset-based fees and commissions are the two largest revenue sources across the group of 91 percent of respondents who manage assets. On average, 598 respondents receive 61 percent of their gross revenues in the form of asset-based fees. Meanwhile, 493 respondents collect, on average, 36 percent of their gross revenues from commissions.
- Retainer and/or flat fees are the third largest revenue source, accounting for an average of 20 percent of revenues for the 362 respondents who charge fees of this type.
- 377 respondents reported that an average of 14 percent of their revenues come in the form of hourly fees. The majority of firms charge a separate fee for financial planning, which is typically a flat or hourly fee.