When You're Serious…

by Bradley R. Newman, CFP®

How Does My Advisor Get Paid

Advisor compensation has become a regular topic of conversation again, thanks in part to the publicity surrounding the release of the Department of Labor's fiduciary ruling. The potential conflicts of interest that can arise from certain types of advisor compensation have become a critical component of an advisor's ability, or more often their inability, to meet a fiduciary standard, which requires an advisor to put the client's interests ahead of their own interests.

There is a common misperception by the public at large that financial advisors provide their services for free, only because very few advisors provide an invoice for services rendered. Most advisor compensation is derived from the front-end, back-end or internal sales charges that come from the products (mutual funds, life insurance, long-term care insurance, annuities, etc.) they sell. Although the fees are required by law to be disclosed, they are too often outlined in the depths of a lengthy prospectus.

As you choose an advisor, or work with the one you have, you should fully understand how they get paid. Advisors who have a commission or sales incentive component to their compensation may have different goals and objectives than those who are only paid by you directly. If you don't fully understand your advisor's complete compensation structure, you should seek out another relationship.

At the end of the day, there are only three ways that financial advisors get paid:

<u>Commission-Only</u>

Some advisors work purely on the basis of the traditional sales model, they only get paid when they successfully sell a product. When they sell a mutual fund, insurance policy or an annuity they get paid; otherwise, they receive no compensation. Sometimes the compensation will be paid up-front in a traditional sales load, other times it will be paid on the back-end as an annual trailing commission or some combination of the two. Additionally, there can be more covert forms of compensation in the form of bonuses for selling a large volume of a certain product or a specified number of transactions.

Whatever the means or combination of sales based remuneration, this type of compensation creates the opportunity for a conflict of interest. The conflict arises because the advisor has an incentive to recommend the products that pay him/her the best, whether or not those products are the best solutions for you.

The attractive aspect of this relationship is that you always know where you stand. You know that the advisor's goal is to sell a product and that not all products provide equal compensation. As a result, you know that you will need to aggressively represent your own interests.

<u>Fee-Only</u>

A fee-only relationship is equally straightforward, but works in the exact opposite way of the commission-only model. These advisors don't sell any products, don't accept any covert compensation and don't benefit from recommending a specific solution. Their only form of compensation is what their clients pay them directly – their compensation is typically in the form of a percentage of the assets they manage, a monthly or quarterly retainer, a flat fee for a specific engagement or an hourly charge for a consultation.

Regardless of the method of compensation, the fee-only model all but eliminates the opportunity for a conflict of interest to exist. If you are the advisor's sole source of compensation, they have no other loyalties and no financial stake in the recommendations they provide you. The advice provided is independent of the products utilized or recommended and in most cases meets the very stringent fiduciary standard.

Again, the attractive aspect of this relationship is that you always know where you stand. However, you know that the advisor works for you and their sole purpose is to recommend the solution that they feel is in your best interests.

Fee-Based

The fee-based compensation classification is a blend of the commission-only and fee-only models and is commonly a misunderstood type of relationship to utilize. Under this regime, the advisor is eligible to receive both direct fees from you as well as commissions and other compensation from the sale of products.

Although the term fee-based sounds very similar to the term fee-only, there are some notable distinctions. The fee-based model is susceptible to the same conflicts of interest that the commission-only model entails. The tricky part of this relationship structure is determining what type of compensation will result from each interaction with advisor and the burden is on you to figure it out and make decisions accordingly.

Closing Thoughts

The most prevalent form of compensation for investment advisors is currently the fee-based model that combines fees and commissions. Despite the trend of clients wanting to utilize an advisor who is both fee-only and fiduciary, many advisors began their careers on a commission only basis and, as you can imagine, walking away from their trailing commissions would be difficult. Other advisors simply find the compensation from selling products like annuities and life insurance just too attractive to pass up.

Regardless of your advisor's compensation model, be certain that you understand how their compensation is being derived and that you get the terms outlined in a clear written statement. Beware, the thicker the documentation that explains the compensation, the more you'll likely be paying.

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