



Ruminations on Investment Costs

Periodically, the financial press discusses costs imbedded in various financial products, especially mutual funds. Some costs are explicit and fully disclosed, but many are not. We fully support disclosure of all costs so investors have information upon which to make good decisions.

Quality financial professionals do *not* try to make less than their competitors, but they *do* try to keep their clients' costs extremely low. That may sound like a contradiction, but many products are designed to pay the salesperson without the client noticing the payment. Furthermore, these products are generally very expensive to own. Following, in no particular order, are some costs investors face. In most cases a good advisor can significantly lower these expenses.

Advisor Compensation. Financial professionals (including us) should be adequately compensated. However, the financial services industry often lacks a correlation between the amount of compensation and the quality of the advice. Among reputable, quality firms, advisor compensation is generally 100 basis points of the assets under management per year. (A "basis point", or bp, is 1/100th of a percent, thus 100 bps is 1.00%.) This is true regardless of the *method* of compensation. However, we believe some methods of compensation align advisor and client interests better than others. Methods of compensation, ranked by popularity, are discussed below along with potential conflicts of interest for each method.

- **Commissions** – The advisor is paid a commission for a sale. Commission-based fees often cause a tendency to focus on the product instead of the process, to turn over the portfolio too frequently, and to neglect the client unless a sale is imminent. The larger the account, the greater the commissions can be, encouraging a bias toward making the account as large as possible even if it is not in the client's best interest. For example, rather than building a larger account, it may be better for the client to pay off the mortgage, enjoy spending some accumulated funds, or gift to family members for estate tax purposes. Also, commission-based sales people are just that – sales people. As such, they are held to a lower legal standard because sales people are not fiduciaries. Frequently, significant commissions are hidden from the client in the product cost particularly in insurance products (including annuities) and B share mutual funds.
- **Asset-Based Fees** – The advisor charges a fee based on assets under management. This is our primary method of compensation, but it is not without its flaws. There can be the same tendency to keep the size of the account high to the detriment of the client (see above), and the advisor gets paid even when not "doing anything." Even though fees were instituted to reduce conflicts of interest, one of the largest U.S. brokerage firms pays their advisors three times as much to recommend equities (150 bps) over fixed income products (50 bps) in a fee-based account. To remove this bias, it is preferable to have the advisor charge the same fee regardless of the product.
- **Hourly Fees** – The advisor charges a fee per hour worked. We do some planning on this basis. One potential problem here is doing more work than the situation justifies. Also, this method, in effect, causes the client to feel that "the meter is running," lessening the likelihood of having a deep enough conversation to get all of the questions answered. In addition, this method is less conducive to ongoing management of a portfolio.

- **Project Fees** – The advisor charges a flat fee for a specific project. We do some planning on this basis as well. It is very similar to the previous method, but removes the “meter running” feeling as well as giving the client certainty about the final cost.
- **Retainers** – The advisor charges a fixed annual amount. While a few firms have moved toward charging annual retainers, it is not common yet. Since the retainer is normally based loosely on the amount of assets under management and the estimated number of hours of work for the coming year, in practice it works like a hybrid of the previous two methods.

Taxes. Few advisors pay attention to managing a portfolio with an eye toward maximizing after-tax return. If all of the investments are in tax-advantaged accounts like 401(k) accounts or IRAs, this doesn't matter, but if taxable accounts are involved, the impact could be significant.

Brokerage Costs. When mutual funds make trades, they frequently “direct” those trades to a specific firm, and the commission is paid by, though generally not disclosed to, the owners of the fund. In return, the firm that executed the trade frequently kicks back (though they would never use that term) what are known as “soft-dollar” perks and freebies such as research.

Trading Costs. Each trade in a portfolio generates a cost from covering the bid/ask spread. As with brokerage costs, this is a hidden cost paid by the owners of the fund.

Expense Ratio. Within a product such as a mutual fund, there are fees for the fund management, marketing expenses, etc. According to our research, the average fund charge is about 140 bps. It would be higher for actively-managed stock funds and lower for bond funds or index funds. Insurance products, hedge funds, etc. can be *significantly* higher.

Turnover Costs. Though not a separate cost, high turnover will generally increase the tax costs, brokerage costs, and trading costs listed above.

Conclusion. Investors typically lose significant amounts through costs they are largely unaware of. Decades of research has shown that these higher costs reduce net portfolio performance. It should be noted, however, that while we believe keeping these costs down is *not* the most important function we serve (the financial planning process, asset allocation, etc. are vastly more important), in many cases selecting more efficient investments for a client can more than cover the advisor compensation.

Notes:

The analysis in this report has been prepared by David E. Hultstrom, MBA, CFP[®], CFA[®].

Mr. Hultstrom is the president of Financial Architects, LLC, a financial planning and wealth management firm. Questions or comments are welcome, and he may be reached at David@FinancialArchitectsLLC.com or (770) 517-8160.



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