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Flat Fees vs. 1% Fees

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When compensating your advisor, which is best for you: paying 1% of your assets under management (AUM) or a flat fee? Answer: the flat fee. The idea is to take the emphasis off of performance and more on overall planning services.

In strict dollars-and-cents terms, a flat fee seems to make more sense for larger portfolios. Yet it isn't that simple. A flat fee (also known as a retainer fee) often ranges from $2,000 to $10,000 yearly, but may go as high as $30,000 or more. It often is pegged to a client's net worth.

Under the standard 1% arrangement, if your investment portfolio is only $100,000, you pay just $1,000. But a $1 million AUM costs you $10,000. Above $1 million or $1.5 million, the fee percentage drops.

A retainer fee may be the same as AUM fee in the first year. But if the flat fee should be locked in for a specified time, such as three years, so what you pay will not change due to market fluctuations or additions and subtractions to the portfolio. That gives you certainty about what you are paying. The chief difference between the AUM and retainer models is that the fee fluctuates using the AUM method.

The financial services industry has many business models. Basically, there's a split between those compensated fee-only and brokers who charge sales commissions per transaction. I believe that fee-only is a superior model because those commissions can mount up – buying a mutual fund, for instance, can lop 5% or more of your investment off in commission.

It is possible that a commission-only advisor can make more early on, but in the long term the fee-only advisor may be more expensive, assuming that the commission planner is not churning the account. The key with a fee-only advisor is that you know what you are paying and the services you are receiving. A fee-only planner should be acting as a fiduciary, where your needs are the first consideration, where as a commission planner has difficulty doing this.

But among the fee-only advisors, there is the division we just discussed, between those who manage money for that 1% or so of AUM and flat-fee types. This can be very confusing for customers. If you meet with five advisors, you will get five different views. It’s hard to comparison shop and really understand what you are paying for. That’s why my firm charges flat fees only.

The flat fee model might *feel* more expensive in some ways. The sticker shock of the yearly retainer can make the service seem expensive compare to paying a portion of your growing account in commissions. (Under both the retainer and AUM model, fees usually are deducted straight from investment accounts.)

When clients pause on this, I explain that for percent-of-assets advisors, the advisor pays sales commissions for asset purchases that you don’t know about. Thus, you don’t have a clear picture of what your money goes to.

Paying a flat fee is a fairer system for the client. Your advisor is supposed to give you advice not just on investments, but also on major life decisions. It is best if the advisor’s own interests don’t cloud the decision-making process.

For example, if a client is buying a new house, the advisor examines his or her finances and crunches numbers to determine an appropriate down payment. A flat fee-only advisor recommends the best one for the client’s situation. An advisor who is paid based on size of the client’s account might not recommend making a big down payment that will require a withdrawal. That house payment lowers the AUM and the advisor’s fee, which is 1% of a smaller amount. In that case, why bother actually crunching those numbers?

I hope AUM-based advisors recommend what is in the clients’ best interest no matter what the effect on the fee. I realize there are advisors who may not give the best recommendation, though. So the flat fee takes away that potential conflict.

The flat-fee model is also good for advisors themselves. Pay tied to the size of the client’s account and market performance sounds fair, but there is little that an advisor can do in the midst of a broad market downturn. In 2008 and 2009, the markets hit a nadir and advisor income plummeted, then climbed back up. A straightforward fee evens out the advisor’s revenue.

I think the AUM model works well when the services provided are limited to asset management only. (There are advisors who charge AUM and then a separate fee for planning, such as creating estate plans, setting up retirement plans and assessing insurance needs.) The majority of advisors charge based on AUM, but more are starting to look at retainer fees. This is part of a profession in transition and growth.

I believe that ethical advisors will be fair no matter how they are compensated. Unethical ones will find ways to be unethical, as well. I like to believe that most fall into the ethical category,

I am all for other AUM fee-based models, as long as the advisor discloses costs and honestly discusses how he or she is compensated. And not with a 30-page legal document, but just a frank conversation with the client.

Divorcing the advisor's pay from assets under management balances the two parties' interests. This lets the advisor focus more on the client's whole financial picture, rather than just the size of the account.

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