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Basic Facts About Advisors

Fee Based? Fee Only? Commission Based? Where's a Person to Turn for Financial Advice?

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What does it mean when our advisor tells us that he is fee-based? What is the best way to pay a financial advisor?

--Norm from Santa Barbara

May 1, 1975 changed everything about how investors pay for investment advice. Until that day, known as “May Day”, commissions were set by the New York Stock Exchange (NYSE) and were fixed. But on that day, the Securities and Exchange Commission (SEC) abolished fixed commissions, and the investment world has never been the same.

Until then, commissions were effectively the only method of paying for financial advice. Now, even as more information has become available, investors have been given more options as to how they wish to pay for advice they receive.

There are now three basic methods to pay for financial advice. Commissions, fee based paid hourly, and fee based as a percentage of assets under management. Each has benefits and disadvantages, so let's consider them one by one.

Commission: The client is sitting at home and receives a phone call from their stockbroker that goes something like this: "Sally, XYZ stock is poised to rise dramatically over the coming year. I think we should buy some." Sally could decide to act on the recommendation, generating a commission for the advisor.

The benefit to using a commission based advisor? There is a one-time transaction fee. The client pays a commission to purchase an investment, and pays no other commission until they sell that investment.

Potential disadvantages? There is no financial incentive for the stockbroker to keep track of the client's investments. The stockbroker may be under pressure from his or her employer to recommend one stock over another for the benefit of the firm, not necessarily for the benefit of the client. And the only way for the stockbroker to generate income is to make changes in the client portfolio, which might lead to unnecessary transactions.

Fee based/hourly: This is where the client and the advisor agree in advance on an hourly rate.

The benefits to paying by the hour? The hourly rate is agreed upon in advance by the client and the advisor, and allows the client to 'put a lid' on the fee they pay for financial advice. There is no financial incentive for the advisor to recommend one investment over another, allowing the advisor to be truly objective.

Potential drawbacks? Similar to the commission based model, there is little incentive for the advisor to track the client's investments. As economic trends change, the investor who paid the hourly rate may or may not be kept up to date. So an investor who chooses to work with an advisor who charges by the hour may still need to track their own investments as well as economic trends that may affect their investment portfolio.

Fee based/Percentage of assets under management: Under this model, the client and the advisor agree to a fixed percentage of assets under management as the fee. For example, the advisor may charge 1% of all assets under management. A hypothetical $500,000 portfolio might incur an annual management fee of $5,000.

Benefits? There is only one way for the advisor to get a raise, which is to see the portfolio grow. The advisor is compensated for keeping current on economic conditions and investment ideas, but there is no financial incentive for the advisor to recommend one investment over another, allowing the advisor to be truly objective.

Typically, the advisor charging an annual fee based on assets under management will provide other services as well under the same umbrella. Estate, education, insurance, and some investment related, tax-efficient planning might all be part of the service the financial advisor provides.

Disadvantages? The investor may find it difficult to pay a fee to an advisor even as the portfolio loses value in a rocky market, which is sure to happen at times.

One other term worth mentioning is **Fee only**. “Fee based” allows some flexibility to both advisor and client to engage in commission based transactions if deemed necessary. Fee only advisors believe strongly that any sort of commission based transaction presents too much of a conflict for the financial advisor, so they charge only fees.

Which is best? There is no clear cut answer to this question. Generally, financial planners will be fee based or fee only, while stockbrokers will be commission based.

Norm, you may wish to interview all three types of financial advisor, looking for the approach that makes the most sense for you personally.

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