Why the Future is Bright for AUM-Based Advisors
May 22, 2017
by J.R. Robinson

Advisor Perspectives welcomes guest contributions. The views presented here do not necessarily represent those of Advisor Perspectives.

Over the past several months, I have been reading Dan Solin’s thought pieces in Advisor Perspectives and believe his gloomy outlook for the planning profession, and, more specifically, for advisors who are compensated via AUM-based fees, is misguided.

I appreciate the contributions of financial planning industry thought leaders, including Dan, Bob Veres, Suleman Din and others, and nothing in this article is intended as an affront to the valuable insights they often provide. However, Dan’s outlook belies the economics of the planning profession and the subtleties of independent advisors’ value propositions.

In this rebuttal, I will provide an empirically supported deconstruction of Dan’s primary lines of reasoning, in order to assess the validity of his underlying assumptions. My goal in presenting this counter-perspective is not to push back against Dan (in fact, I appreciate the discussion he has stimulated as a “devil’s advocate”), but rather to give fellow advisors a framework for assessing their place in today’s competitive market place and for helping them better articulate the value they deliver for the fees they charge.

Economics and conflicts of interest in advisor compensation models

The last two decades have seen a dramatic shift away from commission-based brokerage sales to asset-based investment advisory fees. This sea change was fueled by increasing public awareness of the lack of disclosure and conflicts of interest inherent in the commission-based sales model. Today, asset-based advisory fees are by far the dominant compensation model for the financial planning profession. However, in his December 2016 article, Dan asserted that the seeds of the asset-based fee model’s imminent demise lie in the fact that it is no less conflicted than the commission model. Specifically, the AUM model creates a clear disincentive for advisors to give planning advice that might be in the client’s best interest when the transactions reduce assets under management. For example, an advisor might be reluctant to advise clients to liquidate advisory assets to pay down a mortgage or invest in real estate.
That obvious conflicts of interest may arise under the AUM fee model is not in dispute. In fact, I made the very same point in a 2007 Journal of Financial Planning paper, Who's the Fairest of Them All? A Comparative Analysis of Financial Advisor Compensation Models. I also wholeheartedly agree with Dan’s position that fiduciary advisors would do well to disclose such conflicts in SEC Form ADV Parts 2A & 2B and in their ongoing communications with clients. Where Dan’s argument falters, however, is in his view that alternative hourly and flat-fee planning models, which he suggests will soon displace the AUM model, are somehow “conflict free.”

With respect to hourly planning, a strong case can be made that it is actually the most conflicted of all the compensation models. In simple terms, the advisor has an incentive to bill as much has he or she can, while the client has an inherent disincentive to spend time sharing information with the advisor or to call the advisor for planning advice. For evidence to support this view, look no further than the legal profession, where consumer ire for hourly billing is well documented. Examples of articles on this topic are as follows:

The Inherent Client Conflict of Interest Caused by Hours-Based Billing – Legal Executive Interest

The Conflicted Billable Hour – Lexis Nexis Legal Newsroom

The Tyranny of the Billable Hour – New York Times

Suit Offers a Peek at the Practice of Inflating a Legal Bill – New York Times

In addition to the obvious conflict presented by the advisor’s or attorney’s incentive to wield a heavy pencil in recording billable hours, this model also presents a subtler conflict in the form of so-called “value-billing.” For instance, it might take a planner 20 hours to write a financial plan from scratch, but because he or she has created many plans over the years, that advisor may develop time-saving templates or adopt new technology that may reduce the preparation time down to, say, five hours. Should the advisor now bill 20 hours or only five?

Conflicts of interest in the flat-fee/retainer model are less obvious than with hourly billing, but the basic of the principles of economics reveal their existence. Incentives drive behavior, and in the flat-fee/retainer model, the advisor’s incentive is to charge as much as possible for doing as little work as possible. Support for this innate proclivity can again be found in the legal profession, where retainers have also long been a common form of billing. An excerpt from a public awareness piece produced by the American Bar Association entitled, Attorney Fees: How to Avoid a Conflict with Your Client informed consumers, “There is an inherent conflict in almost every attorney-client relationship – it’s called ’attorney fees.’”

Regarding retainer fees, the ABA piece cautioned, “A lawyer on a fixed fee has an economic incentive not to take that extra deposition – the lawyer gets the savings.” That same principle applies to the planning profession. A fee-only planner who charges only $1,000-2,000 per year may have little incentive to take on time-consuming tasks on behalf of their clients. To borrow a quote from the authors of the best-selling book, Freakonomics, "Morality, it could be argued, represents the way people would like the world to work – whereas economics represents how it actually does work."
From a behavioral finance perspective, another reason why AUM fees have a healthy future is that investors prefer this compensation model to the flat-fee billing model, in much the same way that consumers favor contingency billing for legal services over hourly and retainer compensation. Despite the acknowledged conflicts of interest in the AUM-fee model, consumers also like the idea that advisor-client interests are aligned insofar as the advisor gets paid more if the portfolio value rises and less if it falls. In contrast, when compensation is detached from portfolio performance, clients perceive that the planner has no direct accountability with respect to his or her investment advisory recommendations, since they have no “skin in the game.”

Similarly, behavioral research[2] also suggests that consumers decidedly favor fees that are automatically deducted from their portfolios over being billed directly for retainer fees. In other words, all things being equal, they prefer “out of sight-out-of-mind” fees over salient “in-your-face” billing. This topic was also addressed by Michael Kitces in a 2012 Nerd’s Eye View blog post titled, Why Annual Retainer Fees Won’t Overtake The AUM Model and again in a 2015 reprisal, Retainer vs AUM Fees For Financial Advisors.

Also favoring the AUM model is that fact that asset-based investment advisory fees may be tax deductible while fees for financial planning services are not. This concept was also articulated by Kitces in the following two blog posts, IRS Rules For Paying Investment Management Fees From Taxable And Retirement Accounts and Deducting Financial Planning And Retainer Fees, And The (Tax) Problem With Bundled AUM Fees. Per Kitces, “Under the Internal Revenue Code, expenses for investment management are tax deductible. Accordingly, taxpayers are permitted to deduct the typical assets-under-management (AUM) fee of an investment manager. However, financial planning fees not specifically attributable to investment management (or tax planning) are non-deductible, treated instead as a personal expense.” While the AUM model practice of billing entirely for deductible investment advisory expenses in the course of providing comprehensive planning services is, as Kitces pointed out, not exactly in keeping with the letter of the tax law, it is common practice and the ability of clients to deduct advisory expenses does offer an appealing, quantifiable advantage over the flat-fee planning model.

In sum, contrary to popular perception, hourly and flat-fee planning models are not free from conflicts of interest and do not hold the ethical high ground over the AUM model. Advisors’ and consumers’ demonstrated preference for the AUM model suggests that it will not be displaced.

Pricing and advisor value

Another theme in Dan’s articles is that disruption brought by the emergence of lower cost competitors, including automated advice platforms (“robos”) and flat-fee planners, will hasten the downfall of planners who employ the AUM-fee model. However, I challenge two of his assumptions: (1) that the AUM fee model is inflexible in the face of competition, and (2) that the alpha provided by robos and flat-fee planners is equal to or greater than that provided by the AUM advisors.

In his April 24 article, Dan asserted that AUM planners typically charge 1% for their services and referred to them as “beleaguered advisors coping with a rapidly changing competitive environment.” Fee compression is a real phenomenon. For many years, there was an unspoken, arbitrary industry
standard that 1% is a reasonable fee for an advisor to charge for investment management and/or financial planning services. As Dan rightly pointed out, the recent rollout of hybrid advisory platforms from large scale players, such as Vanguard, Schwab, and Betterment, that pair low fee, algorithmically managed portfolio models with professional guidance for an AUM fee of just 30-50 basis points per year may have recalibrated the 1% paradigm. Put another way, any planner who charges more than 1% must articulate why he or she is worth the additional cost.

However, over the past several years the greatest threat to advisors who are charging level AUM fees of 1% or more is not coming from lower cost/lower service competitors, but from sophisticated, aggressive industry peers (myself included) who operate under a tiered AUM structure. As I have frequently told fellow advisors operating in the “mid-market affluent” client space, I’d like to think that I am pretty darn good at my profession, but could I really justify receiving a $50,000 annual AUM fee from charging 1% on $5,000,000 portfolio? Definitely not. But can I justify an AUM fee that starts below 1% and dips beneath even Vanguard’s 30 basis point bar with scale? I’d like to think so. Far from being beleaguered, advisors who have adopted this model are finding it easier to attract larger portfolios and easier, too, to prey on the robo-advisors.

Of course, while this concept sheds light on how the AUM model is evolving, what is still missing (at least in the public discourse) is, as Dan points out, quantifiable evidence that financial planners provide value at all. They must justify that their value exceeds what hybrid/robo/CFP platforms provide by investing in a portfolio of index funds and offering planning guidance. I agree with Dan that advisor alpha is difficult to measure. Advisor alpha varies significantly from client to client and from year to year and, contrary to the Russel Investments study cited in Dan’s article, it cannot be reduced to an average annual percentage return. That said, advisor alpha is decidedly tangible and easily recognizable to the client, and anyone who is unable to recognize, if not quantify, it fails to understand how the planning profession works.

To begin, the first obvious piece of evidence that consumers at least perceive that advisors provide alpha comes, ironically, from the robo-advisor platforms. Vanguard was able to enter the robo-space late and almost immediately become the dominant player not because of the appeal of its platform of index-fund portfolio models, but rather by virtue of including access to CFP guidance for 30 basis points per year. That many of the other big players in the robo-space, including Schwab and Betterment, subsequently scrambled to rollout hybrid advice platforms of their own is further validation and acknowledgement that the investing public values advice from living, breathing planning professionals.

The question then becomes what can independent financial planners do for their clients over and above what they might receive from a CFP telephone agent at a robo-shop? As I explain to new clients, “You don’t need to pay someone like me to get access to Vanguard Admiral Share Index funds [a staple in my practice]. What you are paying for is sophisticated, entirely customized investment planning guidance to help you invest more efficiently and financial planning guidance to avoid critical mistakes, oversights and omissions pertaining to the non-investment aspects of your financial lives.”

As Dan acknowledged in his April article, tax planning and strategic investment planning are two areas where advisors can add value, but he seems skeptical as to the degree to which advisor alpha can quantifiably push beyond what’s available through the hybrid-platform CFP reps.
In rebuttal, deeper insight into the planning sophistication and expertise that a good planner can provide may be found in Kitces’ recent blog posts, *Tax-Efficient Spending Strategies From Retirement Portfolios* (June 2016) and *The Evolution Of The Four Pillars For Retirement Income Portfolios* (March 2017). These articles demonstrate that such comprehensive portfolio management advice is tangibly valuable and far beyond the scope of services available through even hybrid robo-platforms. The delivery of this advice requires the advisor to be extremely knowledgeable and experienced and to have a detailed, holistic view of the client’s accounts across all institutions and of the nature of all sources of income.

Although I doubt the case I have made for advisor alpha through portfolio management will be enough to win over all skeptics, an even greater opportunity to deliver value lies in holistic financial planning. As I tell all new clients, the biggest and costliest mistakes I see on a regular basis have absolutely nothing to do with picking the wrong stock, bond or mutual fund. Instead, it has everything to do with mistakes, oversights and lack of awareness of arcane rules regarding non-investment financial planning topics...and I catch significant errors with virtually every new family who hires me.

With respect to the threat from robos, it is extremely unlikely that a CFP from a hybrid platform will take the time to search for overlooked opportunities in a client’s employee benefits handbook, challenge guidance given by the clients’ CPA or attorney, review asset registrations and beneficiary designations, pen a determination letter to the IRS, make sure that the people named as alternates or successors in the clients’ estate planning documents are aware of their roles and have copies of the relevant forms, assist in financial aid planning and lowering the net cost of college and/or graduate school, ensure that the client’s insurance risk management strategies are adequate and appropriate, provide guidance for social security optimization, and on and on... Some of the mistakes I catch, or opportunities I find, such as helping a client avoid capital gains tax through an upstream gifting strategy or discovering scholarship money through a client’s employer, are monetarily quantifiable. Others, such as finding an ex-spouse named as the beneficiary on a life insurance policy or encouraging clients to obtain advance directives on their unmarried adult children are not easily valued in dollars and cents. To the client, however, they are unquestionably tangible and valuable. Most consumers will gladly pay for this highly personalized advice.

**Conclusion**

This thought piece is intended to provide a useful counter-perspective to Dan Solin’s recent AP commentary. In closing, I hope the following two points have been effectively made:

First, let’s lay to rest the notion that skilled, knowledgeable financial planners should be threatened by competition from automated or hybrid algorithmic trading platforms. It has never been easier for planning professionals to demonstrate their alpha. The very personal nature of the planning process does not lend itself to being replaced by automation.

Second, reports of the death of the AUM fee model have been greatly exaggerated. While some flat-fee planners provide similar services for less money, such planners need to service a greater number of clients to generate the same revenue. The tiered AUM model catalyzes a trend toward providing higher levels of service and sophistication to smaller numbers of clients with larger asset bases.
Conversely, the trend in the flat-fee space is toward serving younger families that may not have sufficient assets to justify taking on as clients under the AUM model. There is absolutely no reason why planners cannot offer both models. In fact, I do.

John H. Robinson is the owner of Financial Planning Hawaii and the co-founder and CEO of software maker, Nest Egg Guru. His contributions on a broad range of financial planning topics have appeared in numerous peer-reviewed academic journals. Email: jr@fphawaii.com

[1] Five Reasons Your Asset-Based Fee Model Won’t Survive (11/14/16), Five More Reason the Asset-Based Fee Model Won’t Survive (11/21/16), New Developments Imperil Your AUM Fee Model (12/26/16), New Threats to the AUM-Fee Model (1/24/17), Don’t be Misled by Studies on the Value Advisors Add (4/24/17)

[2] e.g., Barber, Odean and Zheng (2005)