

## **The Evolution of Affluent Investment Advisory Fees**

**From COMMISSION to PERCENTAGE to FIXED**

*Advancements in Financial Services Technology have Ushered in a  
New Era in Alternative Fee Structures in Affluent Wealth Management*

As I look forward to my 25<sup>th</sup> year in providing investment advice to affluent investors, I marvel at the changes I have witnessed over the course of my career. When I began in 1994, the investment industry was still firmly established in a commission-based compensation structure when a nascent annual percentage fee structure began to change the fee landscape as an alternative to the transaction-based commission fee option. Decades have passed since the introduction of “wrap fees”, as the percentage on assets fee has come to be known, with the structure growing into the predominate fee arrangement across the majority of the financial services landscape.

### **Technology Marches Forward**

The progress in financial services technology that parallels this 30 year time frame has created tremendous efficiencies in lowering trading and product costs as well as the costs of administering and managing investment portfolios. Technology, as it has in virtually every other industry it touches, has dramatically reduced costs and expanded choice for High Net Worth (HNW) investors.

Initially, these savings have been most readily visible in the discount brokerage battle for “do-it-yourself” investors with \$5 trades and more recently in the emergence of “RoboAdvisors” offering diversified investment portfolios automated by computer algorithm. Yet, despite this march of technological progress, for many HNW investors, advisor fees have seen little structural change over the last several decades since the inception of the percentage wrap fee in the late 1980s. For reference, the birth of the percentage wrap fee structure coincided with the end of the Reagan Presidency and the early introduction of portable cell phones. To recall, these early phones were the size of cinder blocks and required an over the shoulder carry bag for the massive battery pack. Now the smartphone has not only replaced a vast array of old technology, like the Walkman, BetaMax, VHS, and handheld cameras, but has also expanded services like internet access, Maps, Voice to Text, and a whole new universe of Apps. Thirty years later, a room full of this old technology and more fits comfortably in your back pocket. Like the evolution of cell phones, financial technology’s march forward has now ushered in highly competitive fixed fee structures that include an expanded suite of core wealth services.

***Yet the percentage wrap fee structure has remained a constant though out this period of exponential advancement and efficient transformation.***

Why have many affluent investors been largely by-passed in receiving the efficiencies that coincide with this wave of significant technological change? What accounts for the relative slow adoption, from this advisor’s perspective, of the significant efficiencies and potential cost savings created by technology working its way to affluent investors in the form of lower fee thresholds and expanded services in the competitive marketplace?

## The Traditional Percentage Wrap Fee

The answer may lie in the structure of the financial industry's most popular fee arrangement. With a percent fee on assets under management, or AUM, a sample \$1 million investment portfolio may be charged a 1% annual fee which equals \$10,000 per year. The annual fee is generally billed quarterly, and in the case of our hypothetical illustration, a \$2500 fee would be assessed every 3 months based on the end of the quarter account value. Since this is a fixed percentage it is a *fluctuating dollar amount* based on the value of the investments at the end of each quarter. The dollar amount of the percentage fee will rise or fall directly with the value of the investments in the account.

In the case of an extended bull market, if your portfolio grows substantially, the dollar amount of the fee also grows directly with the growth in the account value regardless of whether the advisor has provided any additional level of services. In this sample illustration, the 1% annual fee which began at \$10,000 grows to \$15,000 when the portfolio reaches \$1.5 million in value. The opposite scenario is also true, if the account declines over time the dollar amount of the fee also declines. *Thus, the percentage wrap fee can be said to be a fixed percentage and variable dollar arrangement.*

The automatic increase built into the percentage based advisor compensation has been defended by some industry observers as providing the advisor built in "incentive pay" for successfully growing the assets over time. Conversely, the percentage wrap fee arrangement has also been critiqued as an uncapped compensation structure that has outsized rewards for the advisor when an advancing market tide may be primarily responsible for lifting a multitude of "investment boats" in the water.

Regardless of how the percentage wrap fee may be properly viewed, it has been widely promoted and adopted as a standard compensation structure across the investment management landscape.

### Product Percentage Fees

Below the surface of any advisor compensation arrangement, whether it be commission, percentage, or fixed, there may also exist multiple layers of asset-based percentage product and platform fees that can be a significant addition to the advisor fee in terms of the *total ongoing costs* of the annual investment management fee structure. Internal expense ratios on mutual funds, fund trading costs, and platform fees may all add up to a substantial increase in the total amount an investor may pay each year.

Much like an iceberg, the advisor fee may just be the proverbial tip of the total ongoing annual fee structure. And because these product and platform fees are also almost always percentage-based fees that are linked directly to the value of your investments these additional percentage fees will also rise and fall with the value of the investments.

Like the dollar amount of the percentage based advisor fee, product-based percentage fees will also increase with the value of the account. Thus, in the \$1million dollar investment portfolio illustrated previously, if your product and platform fees add an additional 1% to the 1% advisor fee, the investor may have total ongoing costs of 2% or \$20,000 per year. As a result, an increase of the account value from \$1 million to \$1.5 million overtime would have the dollar amount of the total ongoing fees grow from \$20,000 to \$30,000 per year.

Again, under the traditional fee-based or “wrap accounts” clients pay a quarterly fee, based on the level of assets in the account, for the services of a financial advisor as part of an advisory relationship. In deciding to pay a percentage fee rather than commissions, clients should understand that the fee may be higher than a commission alternative during periods of lower trading. Advisory fees (paid to the advisor) are in addition to the internal expenses charged by mutual funds and other investment company securities. To the extent that clients intend to hold these securities, the internal expenses should be included when evaluating the costs of a fee-based account. Clients should periodically re-evaluate whether the use of an asset-based fee continues to be appropriate in servicing their needs.

### **A Fixed Dollar Alternative**

Today’s efficient financial services technology has paved the way for yet another fee structure that may deliver on technology’s promise of lower costs and expanded choice for HNW investors who wish to retain experienced professional advice. With a fixed fee arrangement, the dollar amount of the annual advisory fee is fixed or capped and not tied directly to the value of the underlying investments. If the investments in the account grow over time, the fee remains fixed and may represent a smaller percentage of the assets over time. Conversely, if the account value falls over time the fixed fee does not decline and may result in a higher percentage fee structure in an extended decline in account value.

To revisit our hypothetical \$1 million-dollar investment account, a fixed fee of \$10,000 equals 1% per year. At \$2 million in assets under management, a \$10,000 fixed fee equals .50% per year and at \$5 million under management a \$10,000

fixed fee is equal to .20% per year. As a result, with the fixed fee structure the investor has the ability to potentially drive down the average annual percentage fee they would be assessed by consolidating more of their assets under the fixed fee arrangement. *Thus, the fixed fee structure can be said to be a fixed dollar and variable percentage fee arrangement.*

Lower cost product alternatives can also help improve the costs associated with underlying products and enhance the overall potential savings of the total annual fee structure. In addition, both the Fixed and Percentage based fee structures may include a bundled suite of services beyond customized investment management such as universal account aggregation of all financial related accounts, ongoing risk analysis and monitoring, and core planning.

In summary, the early impact of technology dramatically lowered trading costs and paved the way for the discount brokerage model. It then ushered in efficient portfolio management and reporting for an annual asset-based percentage fee. Today, technology has created the opportunity for embracing the next efficient fee pathway for affluent investors with additional operational and administrative efficiencies. Enhancements in dynamic portfolio management and product innovation have now made available an expanded suite of concierge level wealth management services for a fixed annual fee. In the current juncture of high net worth financial services and technological innovation, the best of all fee worlds may be flat. Investing involves risks including the possible loss of capital. Alternative investment strategies involve greater risks and are only appropriate for the most sophisticated, knowledgeable and wealthiest of investors.

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