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THE BENEFITS OF ETF FEE TRANSPARENCY

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ETFs present a special challenge to the advisor when it comes to generating revenue: they act like a mutual fund, but don't pay a trailer. They're exchange-traded and commission-based, but have lower turnover than individual stocks. That said, the more actively traded the ETFs, the more a commission-based model can work.

Advisors have primarily used ETFs for tilting portfolio allocations towards certain sectors or regions as a complement to the core strategy. This type of tilting lends itself to a commission-based model, as it implies a relatively short trading horizon. Trailer-paying mutual funds or separately managed accounts (SMAs) can constitute the core of the portfolio, assuring a steady income stream for the advisor, while commission-generating tilting strategies can supplement revenues without the advisor having to depend completely on that revenue.

Having ETFs as a core portfolio holding is, however, a different story. In this case, the core comes without a trailer, and will by its nature have a turnover that's insufficient for decent commission generation.

Consequently, a fee-based model is usually more appropriate for this type of portfolio.

For my team, implementing an ETF-based core portfolio and adapting a fee-based model go hand in hand. But you don't have to 'go ETF' to find advantages in a fee-based service offering.

Fee-based models are available in the brokerage industry either through a firm's fee-based account program, or through SMA platforms. Some financial planners also offer an hourly rate-based remuneration structure.

One of the most often-cited advantages of these models is tax deductibility: the fees charged for managing the clients' assets can be deducted from any investment income these assets generate.

Scalability

Yet a fee-based structure presents several advantages to the advisor. One important advantage is scalability: the percentage charged to clients can be adjusted for the amount of assets managed by the advisor. For example, while a $250,000 account could be charged a management fee of 1.50% of assets, a $1 million account may only be charged 1.00%.

Another application of scalability is household pricing. Assets of a husband and wife may separately fall within a certain fee level, but by combining their assets could put them in a lower fee bracket.

Householding should be considered on a case-by-case basis, however. If both family members are serviced as two completely separate clients, each requiring the same amount of time and work as your other individual clients, then the household discount might have to be less pronounced.

Customization

Another advantage of the fee-based structure is it allows for customization. Although fairness dictates that clients with similar assets, needs and portfolios should pay similar fees, there are always going to be exceptions.

Take, for example, the case of a new client who's getting to know you by investing a relatively small amount in relation to her total investable assets. With the understanding that more of her assets will be coming your way if the experience meets expectations, you may charge her a lower management fee, based on the projected assets under management as opposed to what her current assets with you would dictate.

This is a good way for advisors to show in tangible terms that they're ready to invest in the new relationship. It's a much more constructive approach than the nasty habit of back-end-loading new clients, supposedly to make sure you get paid for hard, up front work in case the relationship doesn't pan out.

A different type of application may involve the sort of client who burdens your team with a rotten attitude and high-frequency calling. Apart from simply firing the client (which is a real option), why not charge him more?

At the very least, make it clear he's not getting the discounts he could be getting for his account size because of the drain in time, energy and resources he represents.

The mutual fund industry offers some limited flexibility, mainly through F- and O-series funds. Yet F-series fund MERs can in some cases start high and limit both scalability and the possibility of customization across the whole spectrum of asset levels. O-series funds require substantial assets and thus limit flexibility to the highest end of the asset-level spectrum.

Questioning transparency

Of course, using a fee-based model means increased transparency. Month after month, the client sees money taken out of her account and going into your and the firm's pockets, in both good times and bad.

When these fees are clearly displayed, investors have a much greater tendency to ask fee-related questions. What are they getting in return? How do their fees compare to others? Worries about transparency and the resulting questions have been a hurdle in the adoption of fee-based models by advisors.

The out-of-sight, out-of-mind nature of embedded remuneration has resulted in some bad habits on the part of clients as well as advisors. Some clients expect to get services for nothing. Advisors, on the other hand, have been comfortable behind the screen embedded fees provide, but have forgotten how to highlight the true value of the services they offer.

In a fee-based business, the advisor has to be able to say, "Mr. Client, this is what you're paying, and this is what you're getting in return." Clearly expressing what we're offering takes thought and practice. Embedded fees have done away with much of the impetus to keep those skills honed.

A first step to developing a language on fees is to imagine the different circumstances in which questions might arise.

Here are some examples:

Paying fees in bad markets

"Why am I paying fees if my portfolio's down over the last year?" Many clients asked this question during the financial crisis because they didn't distinguish between paying for short-term results with paying for a process and services.

Results matter, of course. But short-term results will be the only thing that matters if clients aren't made aware of the advisor's value added, which depends just as much on process and service as on returns.

Paying for index-based portfolios

Questions about the value of advice initially come up when offering an index ETF-based portfolio solution.

A typical question is, "Why am I paying you to manage if you're just using indexes?" Other questions you might encounter are, "Don't you know how to pick stocks?" and "Don't you know how to find hot managers?"

Taking the time to educate the client on the value of your services and how much you're being paid will assuage the concerns behind these questions.

The value of transparency

Transparency requires a careful evaluation of the actual value of the services offered. Does every dollar paid result in a tangible and identifiable value? There's no doubt that increasing the transparency level will raise the bar for client scrutiny.

Yet, fee transparency need not be perceived as negative. In fact, it can be an extremely empowering tool for an advisor's practice.

On the one hand, it can help you reward clients for bringing you new assets. On the other hand, it can help advisors get paid fairly for servicing those high-maintenance and attention-hungry clients.

Fee customization can be a great relationship builder, especially in that first year with a new client who's getting to know you. A fee-based model gives you the freedom to price your services as if you were running your own business. And when it comes down to it, aren't we all?

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