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The Retainer-Based Model of Financial Planning

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THE RETAINER-BASED MODEL OF FINANCIAL PLANNING

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By

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ABSTRACT

Through attending my classes and working part-time at a financial planning firm, I have learned about many different types of compensation for financial planners, the most common being commissions and fees. Western Kentucky University allowed me to travel to San Diego in January of 2017 to attend the TD Ameritrade LINC 2017 conference, and it was there that I was introduced to the concept of a monthly retainer model of compensation. This grabbed my attention because it was a relatively new and unusual form of payment for financial planning services. Through curiosity, this topic encouraged my study of the past, present, and future of financial planning compensation methods. In this thesis, I will explain the multiple ways financial planners can receive income, and the benefits and potential drawbacks of each of those, and an analysis of the monthly retainer model and how it could be implemented alongside current compensation methods or used alone.

Keywords: Financial Planning, Finance, Financial Advisor, Compensation, Commissions, Retainer-based Model

I dedicate this thesis to my parents, Martin and Joleen Stone, who always encourage me to do my best and push myself.

Also, I dedicate this work to my husband, Alex Daniell, who inspires me to work hard and reminds me I am capable of anything.

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VITA

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CHAPTER 1

INTRODUCTION

"How should I get paid?" This is a question all financial planners have asked themselves over the past several years, in an era of rapid changes affecting the practice of financial planning.

Financial planners can be compensated for their work via commissions, fees, or a combination of both. Each method has unique advantages and disadvantages, both for the planner and for her or his client. As financial planners transition away from product sales-driven compensation and toward a fiduciary advisory model, increasingly fees are paid directly by the client. And, among the different forms of fee-based compensation, the annual or monthly retainer model is rapidly gaining increasing acceptance among both advisors and their clients.

CHAPTER 2

TRADITIONAL COMMISSION-BASED COMPENSATION

The most common types of compensation under the traditional umbrella of commission-based compensation are: front-end loads, back-end loads, trailing commissions, and 12(b)-1 fees. In each instance, the financial planner's compensation is tied to the sale or retention of a particular product.

Commission-based compensation is an umbrella term that describes multiple different types of compensation. Commissions come in the form of front and back end load, or a combination. A front-end load is a commission that is paid to the advisor when an investor makes an initial investment ("Front-End Load," n.d.). The client will see the initial investment reduced by the amount equal to the percentage of the front-end load. Front-end loads are usually paid on A shares of mutual funds and insurance products such as annuities, and can often range from 3.75% to 5.75% ("Front-End Load," n.d.), and certain annuity commissions can reach north of 10%. In return for an upfront fee, most A shares of mutual funds will have a reduced ongoing fee. For example, on a $100,000 investment into American Funds Capital Income Builder (CAIBX), there is a front-end load of 5.75%. This means $5,750 is immediately taken out of the investment before it is invested. If that $5,750 were to be invested at 6% for 20 years, it would have grown to be $18,441.03. However, that fund will have a lower ongoing expense (0.61% annual exp ense fee) than its C share counterpart (1.40% annual expense fee). After 10 years, C shares will convert to F shares, which are similar in expense fee structure to A shares. At a certain point, it will be more beneficial to the client to invest in an A share of a fund with a front-end load and lower ongoing fees than a C share without a front-end load but higher ongoing fees. This is called the breakeven point, and is an important conversation for a client and an advisor to discuss. Front-end loads are usually not independently used as a form of compensation for a financial planner, but there are plenty of financial services salespeople who market themselves as advisors and make basically all their income off of front-end commissions from annuity products.

Similar to the front-end loads, back-end loads are also used in mutual fund and insurance sales. Back-end loads, or contingent deferred sales charges ("Back-End Load," n.d.) are a method of compensation for financial advisors that pays them a flat or decreasing percentage of the investment over a set period of years. An investor invests a set amount of funds into a mutual fund for example, and they do not see the money missing from the initial investment. The mutual fund and insurance companies will pay the advisor a portion of the sales charge, and they make up that payment by requiring the investor keep the money in the investment until a certain amount of time has passed, such as five or seven years, or even upwards of 12 years for certain annuity products. If the investor removes the money before the time period is over, they must pay a penalty, often a percentage of their assets invested in that product, which helps to cover the amount that the advisor got paid in previous years. Back-end loads can be more favorable for investors than, say, front-end loads, just as long as they leave their money in the account to grow. However, it also removes some of the liquidity. Similar to front-end loads, the back-end loads are rarely the only form of commission or compensation for the planner. They are often a part of the portfolio, and get paid in addition to other commissions.

Not only do mutual funds often pay a front-end or back-end load, they also often pay trail commissions to compensate the advisor for selling their product. The commission trail is a charge that is paid every year to the advisor as a "service commission. That is, the advisor receiving the commission should continue to provide service to the investor" ("Trailer Fees," n.d.). 12b-1 fees are an example of this type of commission. 12(b)-1 fees are used to market and distribute the fund, as well as to compensate the planner or advisor who sells them ("12B-1 Fee," n.d.). The initial thinking with 12(b)-1 fees was that they would be used to help grow the mutual fund by funding marketing and distribution, and because the mutual fund was growing, economy of scale would come into play, and the 12(b)-1 fee would be reduced overall. This theory has yet to be proven. Normally, 75% of the 12(b)-1 fee is used for marketing and distribution, while the other 25% is paid to the financial planner. The advisor will receive this compensation as long as the fund is held by their client. These charges normally range from 0.25% to 1% ("Trailer Fees," n.d.). Though these service charges are supposed to be to pay the advisor for servicing the client after they buy the fund, there is rarely any regulation of how much service needs to be provided or how often, leaving it up to the advisor to actually "earn" their payment, and giving them the freedom to "do the right thing".

Commissionable products may have a logical place in an investor's portfolio, however many financial planners are moving away from the commission based form of compensation for their businesses. This is due in part to a rise in awareness of conflict of interest. According to the CFP Board, “A *conflict of interest* exists when a certificant’s financial, business, property and/or personal interests, relationships or circumstances reasonably may impair his/her ability to offer objective advice, recommendations or services.” (Terminology,” n.d.). This worry is what encouraged many financial planners to stop using these types of compensations. This has been a fairly recent shift in thinking, however, because product-based sales have been the traditional form of getting compensated. Conflict of interest has played a significant role in this shift because it is easy for the CFP Board, a client, or even another advisor to point out how commissionable products can result in lack of fiduciary duty on the part of the advisor. From the standpoint of a conflict of interest argument, front-end and back-end loads would encourage the financial planner to recommend these products to a client even if the product was not in their best interest because they pay the financial planner a percentage. The more the planner sells, the higher his commission would be. Likewise, commission trails and 12(b)-1 fees incentivize the planner to sell more of these funds, whether or not they are appropriate for the client, by providing more money per sale. Also, the compensation on these products could provide incentive for an advisor to sell a client a new fund with a new front-end load. As previously stated, these products may be appropriate for some clients, but it would be important for those clients to completely understand what they were purchasing, as well as the commissions and compensation his advisor will be receiving from that investment.

CHAPTER 3

TRADITIONAL FEE-BASED COMPENSATION MODELS

Commissionable products are an important part of the history of financial planning compensation. Without them, financial planning my not have developed into its current landscape of compensation: fee-based.

In contrast to commissions, there are advisors that are paid directly by the client fees that are not tied to the sale or retention of particular investments. This model includes several traditional variations: fixed fees for a particular discrete project; hourly fees which vary depending upon the time spent by the adviser in providing advice to the client; or annual percentage-based fees (charged as a percentage of assets upon which compensation is provided, or a percentage of the client's income, or both). A more recent fee model is that of the "retainer fee" for all advice rendered over the course of time, whether charged as an annual amount (typically paid in quarterly installments) or as a fixed monthly fee (termed a "monthly retainer model" or a "subscription-based fee model."). As compared with the more traditional forms of payment, this newer retainer fee model is unique in the way it compensates advisors. Given that retainer fees eliminate most of the existing concerns and disadvantages presented by either product-related fees as well as asset-based or income-based percentage fees, the new retainer fee model could well substantially displace existing other fee models over time.

Fee-based advisors and planners are bound by a fiduciary duty to their clients, meaning they must prioritize the needs and exercise due care. This model of compensation for advisors and planners encourages them to make sure that they are investing their clients' funds with due care into appropriate investments.

The assets under management, or "AUM", method of compensation is a fee paid to the financial planner or advisor that is based upon the amount of assets in the client's investment portfolio. While the percentage charged often varies with the amount of the client's portfolio, a typical fee is 1% a year. Also referred to as percentage-based fees, this method of compensation removes most of the conflicts of interest that arise when advisors receive product-related commissions and 12b-1 fees. The AUM model allows the investor to receive the advice they need without worrying about whether or not their advisor is selling them an unnecessary product, just because it pays well. The client can look at the value of their portfolio assets and know how much the advisor is receiving in compensation for their work.

Using AUM fees, financial planners usually decrease the percentage fee as the amount of assets under management increase. Charging a client via the AUM fee model allows the financial planner to sit on the same side of the table as the client. For example, when the client's investment account value increases, the advisor's compensation increases, creating value for both the client and the investor.

One problem the AUM model is facing is the introduction of robo-advisors in the market (Cussen, 2016). Robo-advisors are "are digital platforms that provide automated, algorithm-driven financial planning services with little to no human supervision ("Robo-Advisor," n.d.) These automatic wealth managers charge a fraction of AUM that a traditional advisor would, because there is no middleman, and they use basic data input from the client and algorithms to invest appropriately. Many investors wonder how an in-person advisor that charges more for essentially the same product is worth the extra cost, however, there is a human aspect to finance, and emotional aspect. Robo-advisors cannot comfort and reassure an investor when the market is down, and they cannot provide advice about college or purchasing a home.

As with advisors that charge based upon AUM, there are many advisors called registered investment advisors that are fee-based. This is another way of saying that they are compensated without the use of commissions or other product-related compensation. Fee-based (or fee-only) financial planners and advisors are only paid with the fee charged to the investor. This fee can be a fixed fee, a flat fee, and hourly fee, or a percentage fee similar to an AUM fee, but there is no commission paid (“Terminology,” n.d.). Fee-based compensation is also thought to be a sound method of complying with the advisor’s fiduciary duty because it removes most conflict of interest from the advisor-client relationship. Fee-based compensation is thought to be more in line with fiduciary standards than commission-based compensation because it puts the advisor on the same side of the table as the client.

While it is true that fee-based models are less likely to encourage an advisor to recommend a product that is inappropriate for a client, there is still a conflict of interest with this model. If an advisor is fee-based, they have an interest in keeping as many of your assets as possible to receive larger compensation. This is not to say all fee-based advisors partake in this practice, but it could be a potential conflict of interest. If an advisor makes 1% off a portfolio, and the client is asking the advisor’s advice about withdrawing $200,000 for a house or taking a mortgage out, the advisor may be more inclined to suggest a mortgage, and have the assets stay under their management, even if this is not the correct answer for the client based on their situation (Wohlner, 2016). Also, if an advisor is going to be paid off of the assets of a client, such as in the AUM model or fixed-fee model, there can be arguments made that the advisor may try to invest the client's money in a riskier manner than appropriate because more risk equals more return over the long run, which equals more pay for the advisor. This could be detrimental to the client if there is a downturn in the market. Flat-fees and hourly fees may seem conflict of interest free, and they are more so than commissionable compensation, but they still carry a risk that the advisor will not provide the adequate level of service promised after the payment is received for a flat-fee. For hourly fees, the advisor may have incentive to drag out a project for more hours than necessary because of the higher fee they could charge.

These methods of compensation for financial advising are grouped under two different umbrellas: commission-based and fee-based. Some advisors use a combination depending on the business they are doing and they type of clients they are working with. Many of these types of compensation have gained and lost popularity as the years have gone by and the financial markets have changed. The rules and regulations have gotten stricter due to historical events, and technology has made an impact on how much an advisor can charge for services.

CHAPTER 4

MONTHLY RETAINER MODEL

Despite there already being multiple ways for financial advisors to get compensated for their work and their time, there is another model which many advisors have yet to implement into their practices. The Monthly Retainer (Subscription) Based Model. This relatively new method of financial planner compensation is based upon a subscription model, much like gym memberships or magazine subscriptions. A client will pay the advisor a set amount every month and based upon the level of payment, the advisor will deliver a specified level of service and accessibility to a client.

The monthly retainer, or subscription model, is useful for younger individuals that may be starting out in their careers and need financial advice. Many advisors that charge via AUM have a minimum amount of asset levels that their clients must meet, which works if the investor has a large portfolio, but for younger clients who need financial advice and do not have the minimum amount of funds (even if in the future they will have a substantial amount), this will not work. That is one reason why the monthly retainer model has created an opportunity for younger investors to get the advice and knowledge they need about important life events. Also, by enabling the financial planner to build helpful relationships with younger clients that may currently be high earners but not yet wealthy, this not only helps the client get the information they need, but it may open the door for that advisor to manage the younger client's assets when they start accumulating them.

The monthly retainer model of financial planning, as discussed above, is the process of paying, on a subscription basis, a monthly fee for financial advice instead of paying a percentage of assets, commission, hourly rate, etc. It is similar to a magazine subscription or even a gym membership in that the client will pay a monthly fee for a pre-specified level of financial advice. A monthly retainer is similar to an annual retainer, or annual flat fee. It is just that it is billed monthly, rather than quarterly. Clients are encouraged, under this model, to call when they have a question of financial nature. The monthly retainer amounts can be adjusted upward or downward, depending on the expertise required to deliver the advice (e.g. more sophisticated tax planning issues), or if the time to deliver the advice goes up or down. This type of compensation for advisors is no longer about selling products for commission as it has been in the past. Now, it is about building strong and lasting relationships with clients, and removing conflicts of interest and making it affordable and accessible to more people. With the monthly retainer model, there is no trying to push or "encourage" a client to buy a product because it has a high commission. The monthly retainer model removes the pressure to sell products that are not useful to the client. This new model is built on service and relationships, not products. This service is what the clients are paying for monthly. They want to know that their financial advisor is available for them to talk to without having to meet a minimum requirement or expect a bill in the mail. These clients and investors have important questions and large financial decisions to make, and they need help. They may not have a large portfolio, but they need help. By being able to pay a subscription for financial advice, the client is able to make smart financial decisions and the advisor is able to build a solid relationship with them. Paying a monthly fee eliminates the instances when a client is sold a product and then forgotten about. Paying a monthly fee allows the client and the advisor to build a strong relationship because they are constantly in touch with the other one.

Knowing how the monthly retainer model works is only part of the equation. Knowing who the monthly retainer model helps is also important. This model of compensation is helpful for almost any person needing financial help. Younger clients are helped by this model because, as discussed above, they often do not have accumulated assets yet, but they have big financial decisions to make such as buying a home and having children. Millennials are the most educated generation to date (Raphelson, 2014), but due to this, also tend to get a later start on their savings due to their lack of disposable income and lower percentage of income at their age versus the previous generations (Franck, 2017). This later start does not mean that these clients will not have substantial savings assets when they are older, but many of them currently do not have them and are unable to qualify for the minimum asset level to be taken on by more traditional financial planning firms, thus keeping them from being able to request sound advice. Not only will the monthly retainer model be easy to fit into the budget of millennials, but it is also familiar for this generation, as many services they use are using this monthly method of payment.

However, the subscription model is not only helpful for millennials and those without accumulated assets, it can also be beneficial for the older or more established clients and those clients with large assets. The monthly retainer model will most likely be a cheaper alternative for them than the AUM model many are used to. Assuming the average cost for a subscription to a financial planner is $1,500 up front and $250 a month continuing, this adds up to a total of $4,500 per year. This is equivalent to a $450,000 portfolio managed at 1% under the AUM model of compensation. If a person with a $1,000,000 portfolio were to join a subscription-based financial planning firm, and pay only $4,500 per year, the financial advisor helping to serve them just saved that client $5,500 per year, which is more than they are paying for the services. This also enables the advisor to have a working relationship with the client and put an emphasis on financial planning, not just asset management. It stands to reason that if the monthly retainer model of financial planning works for those with hardly any assets, as well as those with large amounts of assets, then it will work for those in between.

The monthly retainer model is not just helpful for clients, it is also beneficial to the advisors and planners utilizing it. Financial advisors are able to provide services for clients that are more than just selling a product and checking in once or twice a year. This newer form of financial planning compensation requires that the financial advisor earns their monthly fee by staying in regular contact with the client, keeping the advisor up-to-date about the happenings in a client's life. This also helps to build a lasting relationship, so when the client is able to save a more substantial amount of funds, the advisor is there to help them manage those, too, allowing the advisor to earn more and the client to have a financial planner they already trust and know. This active relationship will be beneficial for the advisor because it will hopefully encourage their current clients to recommend their friends to the advisor, creating a bigger business. Another reason the monthly retainer model is beneficial for the financial advisor's firm is because it allows for a predictable, steady form of income that is not tied to stock market performance. This allows a firm to continue to profit and grow and serve in times of financial market crisis (Moore, 2014). This makes it easier for the advisor to use the income to plan the future and help to grow the business, hire new people, and create a stronger firm that is able to service the client better. Also, the subscription model helps reduce complications in compensation. No longer will the advisor have to worry about making sure that its front-end loads, back-end loads, trailer commissions, and AUM are all calculated and reported correctly. This new model is simpler because it is a relatively steady number that is easy to report. This also helps the advisor maintain a level of transparency in their firm that is easy for the client to understand. For a financial advisor to try to explain how front-end loads, back-end loads, and trailer commissions work to a client that has little financial background, it can get confusing and complicated. The client will be confused about what they are paying and how much, and the advisor may have a hard time helping the client understand. By using the monthly retainer model, the client has a thorough understanding of how much they are paying because it bills the same as many of their other monthly agreements.

Lastly, the monthly retainer model will meet fiduciary standards because it removes virtually all conflict of interest. The advisor working with this model of compensation will be working in the best interest of the client, putting the advisor on the same side of the table as the client, in an even more transparent way than AUM. This fiduciary standard is becoming more prominent and expected in the financial planning world, and to have a monthly retainer model in place, it eliminates the client's fear that the advisor is selling them a product just because it pays the advisor well or recommending a mortgage instead of paying cash to keep assets under management.

Though there are many facets and benefits to a monthly retainer model, there are a few drawbacks, as well. First, an advisor trying to sell this model of pricing may have a more difficult sell than if they were working with AUM or commissionable products because the client will see every month what they are paying. The monthly retainer model is not “out of sight, out of mind.” For a client to think about the monthly amount they will be paying, it may seem like a large amount of money, and since the funds will be coming directly out of their bank account on a monthly basis, it keeps the cost fresh on their mind. This is different than if the advisor was charging via AUM or other ways because then the funding is taken out of the investment account, and although the client can see it on statements, it is not a monthly reminder. Paying monthly may even seem like more of a cost, even if it is less, just because it is within their monthly budget. However difficult of a sale it may be, it is important for the advisor to help the client understand that they will be receiving a higher level of service for the same or similar (or even less) fee they would pay to an AUM or commission advisor (Moore,2016).

There is also the issue of regulations for this type of compensation. Although some companies have been using this model of financial planning for well over two decades, there are still some laws and regulations that make this model more difficult than traditional ones to use. For example, there is a regulation from the SEC that “a registered investment adviser who receives a prepayment of more than $1,200 in fees more than 6 months in advance, must provide an audited balance sheet of the business along with Part 2 of Form ADV, in addition to making further disclosures under Item 18 of the ADV regarding any financial condition that is reasonably likely to impair your ability to meet contractual commitments to clients" (Kitces, 2017). This regulation is in place to make sure that clients are not paying in advance for services and the advisor then shuts the doors and goes out of business. The SEC is trying to protect consumers and make sure that they are not being put at large financial risks.

There are also issues with the accounting portion of this model of compensation. The Generally Accepted Accounting Principles (GAAP) were created to make accounting fair and even for the companies involved and the consumers it protects. However, GAAP is a form of accounting that looks back in time at financial data, not forward in time. The monthly retainer model is based upon a forward-looking moment in time, and therefore does not account correctly under GAAP. This has led many companies to have to upkeep two separate accounting groups for their firms. One to meet GAAP standards and one that actually makes sense based upon the monthly retainer model. Because of this discrepancy, the monthly retainer can be difficult for some companies to implement.

CHAPTER 5

CONCLUSION

In conclusion, there are different types of financial planning compensation methods. An advisor can be paid traditionally by front-end or back-end loads, trailer fees, flat fees, or charging a percentage of AUM. They can also be paid now via monthly retainer models, which are more uncommon. There are arguments for and against each type of compensation and situations in which each type is appropriate. Many firms even use a combination of all of these different types in some aspects. The monthly retainer model, however, is targeted at new financial planning clients, people that tend to fall into the millennial or X and Y generation. These younger clients often do not have large sums of assets, and therefore many financial planning firms will not take their business, but yet they have important questions to ask, they have a need for financial planning help, and they have future wealth potential. These clients are in need of financial help, and they are willing to pay for it. Most of them are used to paying for their services on a monthly business, and therefore are willing to pay financial planners and advisors a monthly fee for financial planning help. This new method is unique, but it is useful in that it allows people without large assets to get the help they need to build a steady financial future, it enables the clients with large assets to get more personalized help on a potentially less expensive basis, it helps the advisor to build solid relationships that are key for keeping a profitable and growing business through referrals, and it helps the advisor to have a predictable, conflict-free form of recurring revenue. There are reasons that the retainer model could not work as well as predicted, and this would be because of the perception that it is more expensive than traditional planning, as well as it is more difficult to regulate and account for. However these downsides do not outweigh the benefits. The monthly retainer model of financial planning is relatively new, it is unique, and it seems to be the perfect fit for what new financial planning clients and financial advisors need to stay current.

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