

Are There Conflicts in Your Portfolio?

By Steve Braun

The financial services industry is famous for terminology that is not readily understood beyond Wall Street. One of those terms, typically used to describe certain financial advisers, is "fee-only." What does that mean? Generally, "fee-only" financial advisers do not work on a commission basis but charge a fee for their services. The structure of those fees and the manner in which they are paid, however, can have a significant impact on the advice clients receive and on their pocketbooks.

There are two basic fee structures used by most "fee-only" financial advisers:

- **Asset Management Fees** – charging a percentage of the assets under management
- **Hourly Rate** – charging per hour of work

It is estimated that 95% of all "fee-only" financial advisers use the asset management fee structure for compensation and here's why.

Asset Management Fees: How They Work

Typically, your financial adviser will manage your investment assets (i.e., IRAs, brokerage accounts, money market funds, etc.) through a single custodian firm (i.e., Fidelity, Charles Schwab, etc.) that he or she works with on an exclusive basis. Your financial adviser is listed as the "agent" on your account.

As your agent, your financial adviser may have discretionary power to invest assets on your behalf or non-discretionary power, in which case only you have access to your funds. In either case, the custodian firm pays your financial adviser the contractually agreed asset management fee on a quarterly basis *directly from your account*. The withdrawal of these fees from your account is shown on your account statement sent by the custodian.

Asset Management Fees: The Intent

Asset management fees sound great in principle. Your financial adviser is paid according to the dollar value of your assets under his or her management. The theory is that the more money you have, the more complicated your finances must be, and therefore the more money it costs to "manage" those assets. Your adviser has an incentive to grow your assets which in turn makes you wealthier. Of course the more assets under management, the more money your adviser makes. Everybody makes more money. It's a win-win arrangement. Or is it?

Asset Management Fees: The Reality

The reality of asset management fees is not nearly as pretty as the theory. Conflicts of interest abound for financial advisers whose compensation is tied to assets under management.

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- **Conflict #1** - The mutual funds most financial advisers recommend in managed asset accounts typically have higher expense ratios. That can cost you an additional 1% per year on average and it has a significant impact on your long-term wealth. For example, if you contribute \$3,000 per year to a Roth IRA and receive an average annual rate of return (after expenses) of 10% for 30 years, that additional 1% expense ratio will cost you \$97,105 over that time.
- **Conflict #2** - 401-k plans and 529 college savings plans are not an adviser's best friends because they normally cannot collect asset management fees on such accounts. Instead, advisers will aggressively push for rollovers of 401-k assets to IRAs so they can collect their fees. Likewise, advisers may avoid 529 college savings plans altogether in lieu of other opportunities. There are many good reasons for rollovers from 401-k plans to IRAs or to choose other college savings plans than a 529 account, but one of them shouldn't be your adviser's paycheck.
- **Conflict #3** - Using an exclusive custodian for client accounts means that the financial adviser is limited to only those investment options available through that custodian. You may not be offered the best selection of investments to meet your needs.
- **Conflict #4** - Financial advisers have an incentive to keep as much of your assets under their management as possible, even if paying down debt, making a large purchase with cash, or gifting for estate planning purposes is more prudent. Such decisions are rarely straight by the numbers and it's easy to argue them either way. You may not get an unbiased perspective.
- **Conflict #5** - Financial advisers get paid whether or not your assets grow. If you had \$500,000 last year, your adviser made \$5,000 at a 1% annual fee. If you lose 20% in the market (now you have \$400,000), your adviser will still get \$4,000 this year. Sure, it's a cut in his or her pay, but it hardly breaks the bank. Advisers also collect their fees to "manage" your money, even if you are engaging in a "buy and hold" strategy.
- **Conflict #6** - You are not an attractive client if you haven't already accumulated sizeable assets. Most financial advisers require minimum asset levels, typically \$100,000 or more. So, the very people who need help the most (those starting out young or those who have had financial difficulty) are left out in the cold.

How Can You Avoid These Conflicts?

At Liberty Financial Planning, we believe that compensation based on an hourly rate for services rendered is just more sensible for clients because it eliminates conflicts of interest. We work hard to provide you with unbiased advice that's best for you.

What's in it for us? Happy clients like you keep more of your hard earned money working for you. We figure you'll tell your friends, family, and business associates about our professional service and unbiased advice. That's how our business grows!

Give Liberty Financial Planning a call today for a free initial consultation to see how we can help you.

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