COMMONWEALTH *financial network*®

Business Growth: Strategies for Pricing Your Advisory Services

Even small changes to your fee schedule can potentially provide a buffer against market volatility and withdrawals—and allow clients to benefit from consolidating assets with your firm.

When was the last time you thought about your advisory fee schedule?

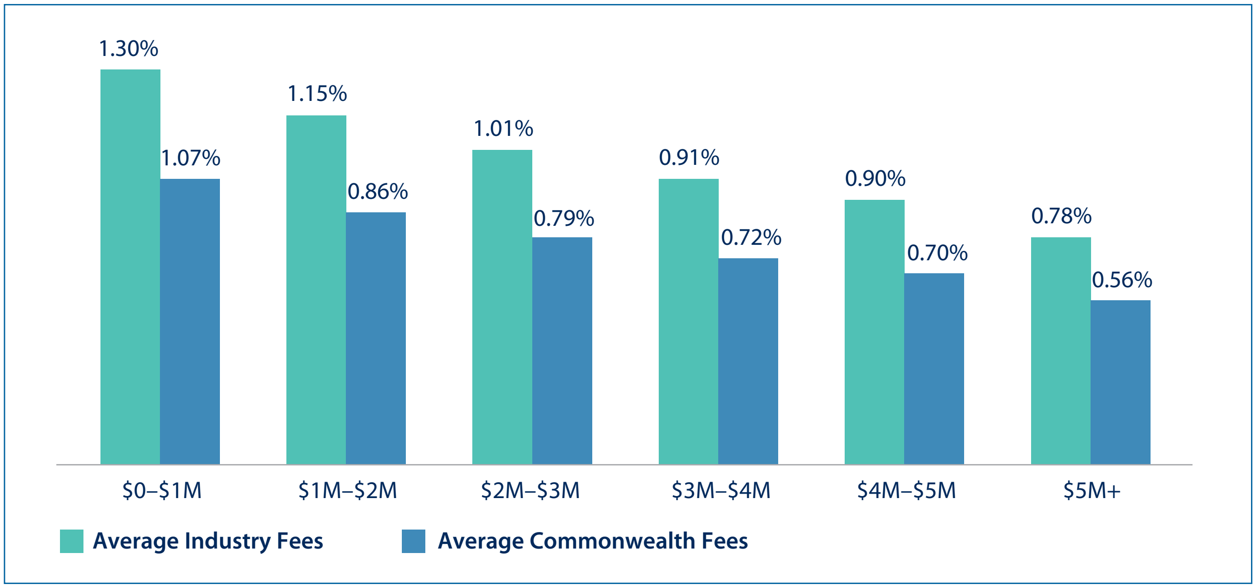
Many financial advisors transitioned their practices to the fee-based model 10, 15, or even 20 years ago. In the period since, as our industry has evolved, advisors have been asked to provide more value and services for the fees they charge. At the same time, the costs of running their small businesses—office space, technology, marketing, supplies, and staff—have continued to rise. Despite the many increases in costs, most independent advisors haven't revisited their pricing schedules. Maybe it's time.

How Much Do You Charge?

Commonwealth's Investment Consulting Services team spends a lot of time talking with advisors about this very subject, and we have done a fair amount of research on it. We pour through extensive amounts of industry data on advisory fees, including surveys and various articles and white papers. We also track, on a quarterly basis, the average fees that Commonwealth advisors using our fee-based Preferred Portfolio Services® (PPS) platform charge their clients.

Figure 1 illustrates the average AUM fees in our industry across various asset tiers. We compare this data against our own advisors' average AUM fees, which, as you can see, trail the industry by a decent margin.

Figure 1. Average Industry AUM Fees Vs. Commonwealth Advisors' Average Fees



Source: PriceMetrix's FeeCheck™

Where do you fall on this spectrum? If your fees are below average, you still may not be convinced that a change is needed. After all, we just told you our own advisors' fees are on the low side. But there is some pertinent data you may want to consider.

The Impact of Underpricing

Let's look back at Figure 1 and consider the tiers with the higher dollar amounts—$2 million and up. If you underprice in these areas, it isn't going to hurt your business because managing these accounts at almost any price is likely to be fairly profitable. A $4 million account for which you charge 72 basis points, for example, earns you $28,800 a year. For $28,800 annually, you could spend a significant amount of time on the account and provide your client with a lot of service while still protecting your margins.

But if you focus on the lower-tier amounts—specifically on the accounts valued below $1 million—you can see where underpricing could have a real impact on your business. If you're like the majority of advisors, you probably have quite a few accounts in these tiers. This is where you need to get the pricing right, as these accounts are drastically less profitable, though probably just as much work to service, compared with your larger accounts.

Take an account worth $200,000 for which you charge a 1-percent fee to manage. This means that your annual fee is $2,000. If you are worth $250 per hour—and, based on your credentials and experience, you may be worth far more—that equates to eight hours per year of work to remain profitable. If you add up the number of hours you spend on average in meetings, prepping, researching, and talking with these clients annually, do you come up with more than eight hours? It's practically guaranteed.

So, if you think you are ready to make a pricing change, this is the client tier you should target.

The Blended Approach

One way to increase the profitability of smaller accounts is to switch to a blended fee schedule. Many advisors in the industry still use a breakpoint schedule. In our opinion, *breakpoint* is a commission term—like the breakpoints associated with A-share mutual funds.

A *blended schedule* is more of the industry standard. It's what institutional money managers and separate account managers use. Let's compare two almost identical schedules—one a breakpoint and one a blended option—as illustrated in Figure 2.

Figure 2. Breakpoint Vs. Blended Fee Schedules

Breakpoint		Blended	
AUM	Fee	AUM	Fee
Less than $500,000	1.15%	First $500,000	1.15%
$500,000–$1,000,000	1.00%	Next $500,000	1.00%
$1,000,000–$2,000,000	0.90%	Next $1,000,000	0.90%
$2,000,000–$5,000,000	0.80%	Next $3,000,000	0.80%
$5,000,000+	0.55%	$5,000,000+	0.55%

Source: Commonwealth

At an initial glance, could a client even tell the difference between the two schedules? They look pretty much the same; however, with the breakpoint schedule, if you do some simple calculations, you'll find that your revenue could drop even as the value of the account increases.

Suppose you handle a $995,000 account and use the breakpoint schedule in Figure 2 to charge for your services. Your fee will be 1 percent or $9,950 annually. If, over the course of one year, the account value were to increase by $5,000 (or slightly more than 5 percent) to $1 million, your fee would actually drop, to $9,000 (0.90 percent x $1 million). So, even though you would have done a good job and helped the client's assets grow, your revenue would drop more than 9.5 percent because of your fee schedule. It is a flawed way to price the value of your expertise and labor.

If you were to use a blended schedule, however, your fee for managing the $995,000 account would be $5,750 on the first $500,000 and $4,950 on the next $495,000, for a total of $10,700. If the account value were to rise to $1 million, your fee would be $5,750 on the first $500,000 and $5,000 on the next $500,000, for a total of $10,750. So you would do better in both cases.

Let's look at another example to further illustrate the additional benefits of using a blended schedule. Figure 3 illustrates the fees earned for managing an account with an initial value of $900,000 and how a 33-percent decline and 33-percent increase would affect the fee.

Figure 3. Breakpoint Vs. Blended Fee Schedules with 33% Change in AUM

Starting Account Value: $900,000							
Breakpoint				Blended			
Initial Fee: $9,000	New Value	New Fee	Revenue Impact	Initial Fee: $9,750	New Value	New Fee	Revenue Impact
33% AUM Decline	$603,000	$6,030	–33%	33% AUM Decline	$603,000	$6,780	–30%
33% AUM Increase	$1,197,000	$10,773	19%	33% AUM Increase	$1,197,000	$12,523	29%

Source: Commonwealth

As you can see, not only is the blended schedule initially more profitable, but it also has the potential to add some downside protection against market losses or client withdrawals. And, as previously described, it offers more upside as the account value grows.

If you are thinking about increasing your advisory fee, moving to a blended schedule could be an ideal way to do it. Typically, it is fair and equitable, not to mention an industry standard. It also encourages clients to consolidate assets under your management, as new money (or portions of new money) they bring to you may be managed at a lower rate.

Adjusting your advisory fee schedule isn't (and shouldn't be) your only option when it comes to pricing your business, however.

Do You Charge for Financial Planning?

Advisors who maintain a pure AUM schedule have a tendency to bundle services beyond asset management under their AUM fee. We sometimes refer this bundling of services as "1% and everything else." Today, more and more advisors are realizing the advantages of moving away from this model—separating their asset management and financial planning services and charging planning fees for the additional work they do outside of managing assets.

If you haven't yet made this leap, the following case study provides a cautionary tale of a reformed "1% and everything else" advisor.

> Faith started working with a small business owner several years ago. Like she did with all of her clients, she positioned herself as the client's CFO and made it clear to him that she wanted to be the first call for all matters financial. For the privilege of having a personal CFO, the client would pay Faith an AUM-based fee.
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> The amount was modest, as the vast majority of this client's net worth was tied up in his business. Faith knew this but figured that if she could prove herself over the next couple of years, she would earn the opportunity to manage the proceeds when the client ultimately sold his share of the business. As hoped, the client eventually came to Faith and asked for her guidance in facilitating the sale. Over the next six months, Faith spent considerable time in meetings with the other principals, attorneys, and accountants, all in an effort to optimize the proceeds for her client.
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> As you may have guessed, this tale does not have a happy ending. The client did sell his business and netted mid-seven figures in the process—but Faith did not end up managing the proceeds. What went wrong? Faith's pricing model had effectively given this client a blank check upon which he could draw unlimited financial consulting support at no additional cost, and then he took his business elsewhere.

This is an extreme example and hopefully not a common experience. Nevertheless, how can you ensure that you don't find yourself in a similar situation? If we can paraphrase a bit here—"hoping to capture additional assets" may not be the most credible strategy for growing revenue. You always want to clearly define the services that are to be rendered for the fees paid. You can still bundle a variety of services under the AUM fee, but you need to ensure that you are doing so in a cost-effective manner.

Clients with more AUM might be entitled to more bundled services, for example, while smaller clients—perhaps younger investors starting out—receive the basics, such as budgeting or a simple financial plan. (Remember: It is generally not the clients with $1 million or more in investable assets who blow up your margin.) Then, if clients want to avail themselves of additional services, make it clear that you reserve the right to charge hourly or project-specific fees for requests that fall outside of your standard service model.

As with the blended fee schedule we discussed above, an ancillary benefit of developing a service model where you charge ongoing consulting fees is that those fees can theoretically act as something of a hedge during a market drawdown. Consider Figure 4, which is a simplified schedule illustrating an AUM fee for accounts of various levels but also adds an annual consulting fee for specific services. The Total Revenue column is the sum of the AUM fee and the consulting fee. The 20% AUM Decline column is the sum of the annual consulting fee and the AUM fee if investable assets are reduced by 20 percent.

Figure 4. Sample Fee Schedule Incorporating AUM and Consulting Fees

Investable Assets	AUM Fee	Annual Consulting Fee	Targeted Consulting Services	Total Revenue	20% AUM Decline	Revenue Impact
< $100,000	1.35%	$1,000	• Basic Financial Plan • Retirement Planning • Education Planning • Budgeting	$2,350	$2,080	–12%
$500,000	1.20%	$1,500	• Financial Plan • Estate Planning • Risk Management • Tax Management • Stock Option Planning	$7,500	$6,300	–16%
> $1,000,000	1.00%	$2,500	• Advanced Financial Plan • Wealth Transfer • Risk Management • Tax Management • Stock Option Planning • Coordination with Other Advisors • Charitable Planning	$12,500	$10,500	–16%

As you can see, the inclusion of an annual consulting fee can function much like an allocation to fixed income does in client portfolios and dampen volatility. Of course, this assumes that clients will continue to pay the consulting fees through good markets and bad. As long as the targeted services are tightly in sync with client needs, there is plenty of value to be delivered.

Knowing Is Half the Battle

To clarify, we are *not* suggesting that you raise your AUM fees and start charging for financial planning merely because you may be charging below the industry average, or that you rip up your existing contracts with clients and have them sign on with you at a higher rate. Advisors considering raising their fees are always worried about losing clients, and those actions could send them fleeing your practice en masse.

If you do decide to shift to a blended schedule, however, you will likely see your overall fee revenue increase. Would such a change put your fees more in line with the competition? Yes and no. Most likely, your fees would still rest below the industry average, but your smaller accounts would be more profitable.

If you are uncomfortable approaching existing clients to modify their fee structure, consider adopting a blended schedule and charging consulting fees for all new client relationships. Many advisors have found this method easier to implement. Just be sure that you completely commit to the new pricing going forward and bill all new accounts at the revised rates.

As you become more comfortable with the new pricing, you can gradually introduce it to existing clients as you meet with them for periodic reviews. With sensitive matters such as fees, it's usually best to discuss the topic during a face-to-face meeting. This helps reduce miscommunication and gives you the opportunity to address any client concerns immediately. It's also the time to reiterate your value proposition and commitment to service. Remember: confidence is all-important when presenting your fee structure to clients.

And if you're comfortable with your fee schedule as it stands, that's fine; but now that you know how you compare with the competition, you'll be better prepared—and therefore more confident—to discuss and stand firm on your fees if clients or prospects attempt to negotiate.

The preceding includes hypothetical examples, which are for illustrative purposes only. No specific investments were used in these examples. Actual results will vary. Past performance does not guarantee future results.

PPS accounts are managed accounts, and managed accounts, like all investments, are subject to risk. A managed account can fail to meet its investment objective. Aggressively managed accounts, accounts that concentrate on more volatile investments—such as small-company stocks—and accounts whose managers' investment styles are suffering in the current market are likely to fall more sharply in value under certain market conditions than conservatively managed accounts. But they also have the potential to gain more in rising markets.

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