

# Financial Planning

## Making the Switch

*As advisers shift from a commission-based model to a fee-based one, how are their practices handling the change?*

By Ed McCarthy

May 1, 2005- Loren Kayfetz, CFP, CLU, ChFC, and president of Personal Financial Consultant Securities Corp. in Mountain View, Calif., had built a successful commission-based planning firm that included a wholly owned broker-dealer. Kayfetz frequently defended the commission model on industry Web sites, but in March 2004, he started converting his practice to fee-only and is now closing his broker-dealer. He works with 380 client accounts that hold \$80 million in assets, so the decision to change models was significant.

His motivation? "I was tired of being dragged through the mud by the unfortunate actions of many of the retail brokerage firms, mutual funds, and other groups whose scandals have rocked the industry," he explains. "Having a client receive a statement from an offending mutual fund company with my name on it wasn't very flattering to me or to my stature with that client."

Conventional wisdom says that fee-only is the way for financial planners to go: It seems more objective and appears to align the interests of planners and clients more closely. And certainly, the recent decision by the National Association of Securities Dealers to adopt the "Merrill Lynch rule," which lets broker-dealers offer advice without becoming registered investment advisers (RIAs), will only accelerate the trend, as planners attempt to distinguish themselves from their commission-based competition. But is going fee-only always the right move? And what challenges do planners face if they decide to adopt the fee-only model?

Several recent surveys bear out that the commission-based model is losing ground. The Rydex Advisor Benchmarking Research Study tracks RIAs' mix of revenue (see "Following the Money," below). Among the more than 1,000 RIAs who responded, commissions accounted for just 2.57% of revenues in 2000; that figure had fallen to 1.2% by 2003.

## FOLLOWING THE MONEY

**As the number of advisers grows, the share of income generated by commissions is shrinking**

Sources of income for broker-dealers	2000	2001	2002	2003
Commissions	2.57%	2.11%	1.91%	1.20%
Planning/ consulting fees	11.49%	17.62%	23.45%	20.15%
AUM fees	85.39%	80.25%	74.25%	78.65%

Source: Rydex Advisor Benchmarking Research Study

In contrast, a study by the Financial Planning Association/Financial Research Corp. (FPA/FRC)

of 600 financial planners, "Understanding the Delivery of Advice and Financial Planning Services," reported that the 162 independent, unaffiliated RIA respondents got 10% of their total compensation from commissions in 2002. The result for the Rydex Advisor Benchmarking study that year was 1.91%.

The FPA/FRC survey found significant differences existed in compensation sources among the survey respondents. Planners affiliated with regional, independent, and wirehouse broker-dealers earned between 50% and 52% of their total compensation from commissions, while those affiliated with independent RIAs reported just 30% from commissions.

The CFP Board's membership data also indicates that commission-based advice remains well entrenched in the planning business. As of March, 69% of the CFP registrants held insurance licenses, while 68% of them held securities licenses. Those percentages have remained largely unchanged in recent years, the Board reports.

Anecdotally, the sense among financial planners interviewed for this article was that the shift to the fee-only model continues to gain momentum. Even some advisers who still work solely on commissions would consider a switch to fees under the right circumstances. Bob Russell, president of American Financial Solutions, a commission-only firm in Largo, Fla., says that the majority of his clients are not interested in paying fees because they believe that commissions will cost them less in the long run. Most of the planner's clients have somewhere between \$100,000 and \$1 million of assets, and their primary investments include variable annuities, exchange-traded funds, mutual funds, and securities.

Still, Russell doesn't rule outswitching to fees someday. "I'm not opposed to the fee-based model," he notes. "That's a direction we could consider in the future."

Those planners interviewed for this article who recently shifted their practices to a fee-only structure share several characteristics. All worked for brokerage firms, where they got valuable training but eventually became disillusioned with the business constraints they perceived.

James Kibler, CFP, spent five years as a commissioned broker, including three years with Oppenheimer, where he had built his business to \$40 million in client assets. He left at the beginning of 2004 to launch Eldridge Financial Planning, a fee-only advisory firm in New York.

Kibler knew that he would be sacrificing the benefits of working for a big financial services firm when he started his own shop. "You don't have to reinvent the wheel when you're working in an established system," he says. "They train you to sell financial products and then you do it. There's also a significant amount of support from staff and from the branch system; there was also name recognition to a small extent. All of that can be useful."

But Kibler found that the commission model restricted his work with clients, particularly because his investment recommendations were limited to those that appeared on the firm's selling list. In addition, the broker's move toward higher-net-worth clients, a common theme in the industry, prevented him from working with some prospects. "It was possible--but not very profitable--to deal with smaller clients," he recalls. "To make it work, you had to charge them as much as 2% annually or 5% in upfront commissions. That's really a difficult hurdle to overcome as an investment manager."

J. Patrick Collins, CFP, spent four years at Merrill Lynch before leaving in October 2004 to form fee-only J.P. Collins & Associates in Towson, Md. Collins oversaw roughly \$30 million in client assets at Merrill, where he benefited from excellent training in investment-management and client-acquisition skills. But the firm's emphasis on rapidly increasing the number of clients on his list bothered him.

"My vision of how I wanted to work with my clients was going in a different direction from Merrill's," he explains. "I wanted to work with a small core group of clients. They want their advisers to acquire as many clients as they can and put them in as many different investment products as they can. Many of the people in my office who had been there for at least 10 years

or longer had 500 or 1,000 clients. You become completely reactive at that size. You're proactive with maybe the top 5% of your clients at that point."

Changing from commissions to fee-only is a challenge on several fronts. If the planner's clients are in investments that are proprietary to the firm, it can be very costly for the client to change holdings. There is also a potential problem with clients' perceptions: You sold me this product but now you're telling me that there's a better way for me to invest? Combine these problems with the expense of setting up a new operation, and the planner's finances can suffer during the transition.

Brent Hicks, CFP, recognized these problems when he founded Portland, Ore.-based FocusPoint Solutions. The firm assists advisers who want to transition to fee-based or fee-only models, and it has worked with roughly 100 advisers since 1989.

Hicks has discovered that planners express several motivations for making the transition. "Most believe that a fee approach is a more profitable, efficient, and client-oriented business model," he says. "But there also some advisers now moving to fees because they feel that they're supposed to, not because they want to. Industrywide and in the press, it's almost become a given for financial advisers to become fee-based in one way or another."

In Hicks' experience, transitioning advisers often fall into several traps. One common error is a failure to clearly define the desired post-transition business model. Hicks says that advisers who start the process without a plan often latch onto any arrangement that generates a recurring revenue stream. As a result, they are forced to manage multiple systems and procedures, since each pool of money requires a different structure and system.

"They may have started out thinking that C shares were the solution to becoming fee-based," he says. "Then they started using third-party money managers or some separate accounts, or perhaps their broker-dealer had a fee-based platform. In the process, they may have created as many as five pots of fee-based money--plus they're still doing some commission work. That's a nightmare structure, and it turns out to be a horrendous overhead issue."

The initial post-transition financial results for planners vary. Collins anticipates his net income will increase by 50% during his first full fee-only year. Kibler's transition went smoothly, but his income dropped 30% during his first fee-only year. He attributes much of that slowdown to the fact that he sold a large part of his brokerage book to raise the funds he needed to start his new firm, a decision that reduced the number of clients that he could take with him.

Ray LeVitre, CFP and head of Net Worth Advisory Group in Midvale, Utah, endured a much greater income loss. He was working as a branch manager with Merrill Lynch when he decided in March 2002 that it was time to make a change. LeVitre made two big errors in his transition to fee-only. First, most of his accounts at Merrill were not easy to convertible to fee-based management. It took him almost 18 months to convert those clients who followed him--approximately half his previous client roster--from commissioned products to no-load and asset management accounts.

His second error was informing his colleagues at Merrill about his plan to leave. As a result, the firm was prepared for LeVitre's resignation, and it moved rapidly to enforce a noncompete clause that barred him from contacting any of his former clients.

Those two factors had a direct impact on his business. "The transition was brutal," LeVitre recalls. "I went for about a year-and-a-half with no income at all. This is the first year I'll be back to the income level I had in 2002."

The problems that can arise during the transition lead some advisers to the multiple-systems limbo Hicks mentioned earlier. He believes that much of the difficulty can be avoided if the adviser develops a clear pre- and post-transition business plan.

"There is a misperception that the transition from commissions to fees generally is slow and costly," Hicks says. "Contrary to that, we believe that the faster you make the transition, the better it is--assuming you have a business plan. The single biggest mistake that we see results from sliding into the transition. Instead of looking at it as a new business and developing a plan for that business, the adviser makes a gradual transition and gets stuck somewhere in the middle."

But is the fee-only model always in the client's best interest? Steve Bailey, RFC and president of HB Financial Resources in Charlotte, N.C., believes most investors aren't very concerned with the fee-versus-commission issue.

"Most of the general public doesn't understand what the differences are between fee-only, fee-based, and commission," he says. "It's the news media that loves all the hype. Financial planners will get compensated for doing the work one way or the other, and the cost to the client probably is going to come out the same over a five-year period."

While Bailey, who serves as president of the Middletown, Ohio-based International Association of Registered Financial Consultants, doubts the public's comprehension of the compensation issue, he recognizes the business value of fees. In 1995, his firm's revenues consisted of 70% commissions and 30% fees; today, it's 80% fees and 20% commissions. "I like the continuity of income," he says candidly. "I like the fee basis because I get paid each month as long as I'm doing a good job for the client."

## PAID BY THE TRADE

Commissions as percentage of total compensation

Type	%
Insurance Broker-Dealer	63
Regional Broker-Dealer	52
Bank Broker-Dealer	52
Independent Broker-Dealer	50
Wirehouse/ Full-Service Broker-Dealer	50
Overall Average	45
Indep. RIA w/Broker-Dealer	30
Independent RIA Unaffiliated w/Broker-Dealer	10

Source: FPA/FRC

Jeffrey Rattiner, CPA, CFP, and president of JR Financial Group in Centennial, Colo., consults with advisory firms on their choice of business models. He also discusses the topic in his book, *Getting Started as a Financial Planner* (Bloomberg Press), and he stresses that there are multiple factors involved in selecting a model.

"The model that you use has to be true to your heart--it has to be something that you totally believe in," he explains. "Whether you decide to go commission-only, fee-only, or a combination, there is no right answer. The right question is, are you doing the best thing for the client?"

Rattiner uses a two-tier model that lets him work with smaller accounts. Clients with \$100,000 and above go into a money management model; less affluent clients are offered load funds.

"The planning process that we go through with each client is the same no matter how much they have to invest," he says. "I'm very hesitant about turning any clients away. I feel that just because they don't reach the \$100,000 threshold doesn't mean that they don't have needs, and ethically I feel the need to service them. But our number-one rule is to stay in business--if you don't stay in business, you can't help the client. Clients have to realize that you are going to get paid whether it's built into a commission product or you charge them a fee."

The fee-only advisers interviewed for this article believe their models also can serve less affluent clients profitably. These planners have asset under management minimums, but they will switch to hourly or project-based billing for smaller clients.

Kibler's business model accommodates hourly billing and retainer fees for financial planning in addition to assets under management. LeVitre and Collins will also switch to hourly billing if the situation warrants that approach.

"Investors with \$25,000 or \$50,000, for example, might not fit with a broker, but I work with them for an hourly fee," Collins explains. "It saves clients money, since I can direct them toward no-load products, and they can avoid expensive commissions."

The fee-versus-commission debate carries over to insurance products as well, and some fee-only planners mentioned that they are considering obtaining insurance licenses so they can handle those products for clients. Ricky Grunden, CFP and president of Grunden Financial Advisory in Denton, Texas, gave up his insurance license in 1999 and has worked as a fee-only adviser since then. Recently, however, he has been considering the reinstatement of his insurance license.

He now works with a local commissioned agent who handles policy applications and subsequent paperwork for Grunden clients. Although the agent has done a good job, Grunden says it is time-consuming to stay abreast of the contracts and monitor policies. There is also the problem of uncompensated time to analyze complex cases.

"We do all the work, especially with a large estate planning policy, and then we send the policy down the street for the agent to pick up a \$25,000 premium," Grunden says. "There's a lot of work that's done there, and somebody's going to get the commission." In addition to life insurance contracts, Grunden is also considering how single-premium deferred and immediate annuities might fit into clients' retirement plans as fixed-income alternatives.

Renewing his insurance licenses would force Grunden to relinquish his fee-only status with NAPFA, so he is instead investigating no-load and low-load contracts. The planner prefers to remain fee-only but expresses concern about how he would be compensated for working with the noncommissioned products. (See "Protection Money," below, for a look at how insurance compensation works.)

Is Grunden worried that he might lose investment clients if he reinstates his insurance license? "I wouldn't just run out and get my license," he says. "I'd probably discuss it with a good number of my clients and explain what I'm doing and how it would benefit them. And I wouldn't be looking for life insurance sales; we won't market it. I suspect our activity will be minimal--just an additional service for clients who absolutely need it."

It is impossible to estimate accurately how many planners are giving up commissions and switching to the fee-only model. NAPFA's membership has almost doubled in the past six years to more than 1,200 members, but the organization's stringent definition of fee-only compensation prevents many "primarily fee-based" planners from joining. The good news for those considering the switch to fee-only is that they will find more helpful resources than their predecessors had.

Carl F. von dem Bussche, a CFP and president of Financial Guidance Group in Palm Harbor, Fla., singles out NAPFA's FOSTER (Fee-Only Support Training Education & Resources) distance-learning program as an example of these resources. The FOSTER program covers numerous aspects of starting and growing a practice, and the instructors are successful fee-only planners themselves.

There are other sources of assistance for making the transition as well, although most newly minted fee-only planners still face a formidable challenge. "It's still tough to get your business up and running and become profitable, but you now have FOSTER and turnkey franchise-type operations like Cambridge Associates and the Garrett Planning Network that can at least give you a track to run on," von dem Bussche says. "It is absolutely better than when I transitioned in 1995."

### **Protection Money**

*How fee-only planners sell insurance--without collecting a commission.*

Personal insurance products--life, disability, annuities, etc.--pose no problem for commission-based planners: They can get licensed, make the sale, and collect the commission.

Fee-only advisers face additional challenges. The first is navigating each state's regulations on who can advise on personal insurance. For example, Washington state permits only licensed brokers to advise on life insurance, according to George Middleton, CFA, CPA/PFS, of fee-only Limoges Investment Management in Vancouver, Wash. John Gay, CFP, of fee-only Frisco Financial Planning in Frisco, Texas, reports that in his state, planners who wish to advise on insurance but are not licensed insurance agents must register as life insurance counselors.

Collecting compensation for insurance-related advice is the second hurdle. Time spent on insurance counseling generally doesn't fit neatly into the assets-under-management model. Gay charges a flat fee for life insurance needs analysis, and he bills by the hour to research specific policies. In some cases, he works with clients' agents; in others, he researches and recommends no-load and low-load products.

Keith Heichel, CFP, ChFC, of fee-only Pinnacle Wealth Planning Services in Mansfield, Ohio, says that his firm takes a similar approach. Pinnacle charges clients a flat fee of \$250 per policy for analysis if those policies are reviewed outside a financial planning engagement. If Pinnacle researches a new policy for the client, the firm charges an implementation fee that can range from \$1,000 to \$15,000. Heichel says that the implementation fee is based on several factors, including the complexity of the policy and the situation, but that the average fee is \$3,000.

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