The Business Benefits Of Transitioning From Commissions To Fee-Based Advisory Accounts

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Executive Summary

Since the late 1990s, the broker-dealer community has been increasingly transitioning away from traditional commission-based accounts, and towards fee-based alternatives instead. Facilitated first by a proposed 1999 exemption under Rule 202 that would allow broker-dealers to offer fee-based accounts without being registered as investment advisers, and then transitioning fully to dual-registered or hybrid RIA arrangements (after the proposal was struck down in 2007), the shift has been substantial, with leading broker-dealers going from less than 10% of fee-based revenue to more than 50% today.

For any individual advisor, though, the reason to transition to doing fee-based advisory accounts isn't just because the broker-dealer prefers it, but simply because it allows for building a bigger and more successful advisory business. The reason is rather straightforward: because commission-based business is transactional, and will always be constrained by the number of clients the advisor can personally see and sell, while a recurring revenue advisory business makes it possible to separate "selling" clients from the less-expensive process of servicing them. Or stated another way: after several years of commission-based business, your income on January 1st of a new year is still $0 until you get a new client, while with an advisory business, after a few years you can be financially successful with *no* new clients, as long as you give quality service to the ones you already have.

The challenge, though, is that transitioning *to* fee-based advisory accounts is not easy. As an advisor, it's necessary to redefine your value proposition to justify charging an ongoing advisory fee, and persuade clients to make the change with you. And those reinvestments into the business have to happen just as revenue *declines* in the transition – because even if advisory fees may be more stable in the long run, in the near term it's just less money coming in the door.

Nonetheless, with the regulatory winds around the globe blowing increasingly towards no-commission fiduciary advice, arguably the transition to fee-based advisory accounts may be inevitable anyway. But given that recurring revenue advisory fees are facilitating the growth of bigger advisory businesses, which also get better valuations in the marketplace, it's a good shift to make, regardless of whether the regulators ultimately require it or not!

Author: Michael Kitces

Team Kitces
Michael Kitces is Head of Planning Strategy at Buckingham Wealth Partners, a turnkey wealth management services provider supporting thousands of independent financial advisors.

In addition, he is a co-founder of the XY Planning Network, AdvicePay, fpPathfinder, and New Planner Recruiting, the former Practitioner Editor of the Journal of Financial Planning, the host of the *Financial Advisor Success* podcast, and the publisher of the popular financial planning industry blog *Nerd's Eye View* through his website Kitces.com, dedicated to advancing knowledge in financial planning. In 2010, Michael was recognized with one of the FPA's "Heart of Financial Planning" awards for his dedication and work in advancing the profession.

The Challenge Of Building A Real Commission-Based Business

Successful salespeople have always had a lot of opportunities to make money. The classic compensation for salespeople – commissions – provides in most industries a sizable payment for each deal or transaction. As any salesperson knows, part of the "cost" of the commission is not just the time it takes to work with the client who says "yes", but also all the "no" responses that had to occur in order to find that "yes" opportunity. In other words, it's not about the size of the commission for each completed transaction, but how the commission averages out across the business over time.

The challenge, however, is that operating as a salesperson is fundamentally limited in building a true business. Because in the end, it's only possible to see "so many" prospects to find opportunities to do business. And it's only feasible to make "so much" on each transaction. Which means if you want your income to grow, you must either:

1) See more people;

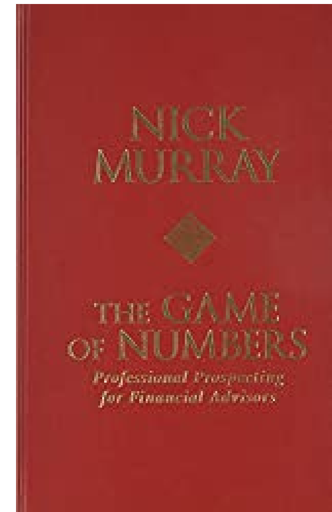
2) Close more sales; or

3) Earn more on each sale, which means either:

a) Doing bigger transactions; or

b) Selling products that pay bigger commissions

For most salespeople, they hit the "wall" on growth in that order as well. First, it's "A Game Of Numbers" to reach more prospects and find at least a few who will say "yes". Then it's learning to sell better, so that you can close more prospects and convert more business from the meetings you're having.



But at some point, anyone/everyone in the commission-based business starts to top out. You're seeing as many people as your time allows, and closing as many as you possibly can. There's just no more room to increase the volume, because you're out of time. At that point, the only path left it to try to move "upmarket" and grow your income by hunting for bigger fish (if you can find/reach them), or switch up what you're selling for a product that pays a better commission.

The fundamental challenge is that as a "business", it's a purely transactional model, still constrained by *you*, and your individual time and capacity to go out and make transactions happen. It doesn't grow beyond you, because it's difficult to hire staff and expand resources when every January 1st, you wake up and have zero income until you go see people, close them, and get some sales. At best, you might have a little bit of ongoing income from prior trails, but it's usually not enough to build much infrastructure, beyond perhaps a staff support person whose salary is covered by the 0.25% 12b-1 servicing fees.

Which means in the end, it's not really a true "business" at all, because it's entirely reliant on your individual ability to do the "work" of finding prospects and closing them. When you don't work, there's no income. When you slow down, the "business" slows down. And when you retire or pass away, the business ends. If you try to sell it, at best a buyer might pay 1X your trailing 12-month revenue, for what is basically just a list of warm leads that a new salesperson can call upon to try to make some new sales.

How Fee-Based Builds A Business That Commissions Never Could

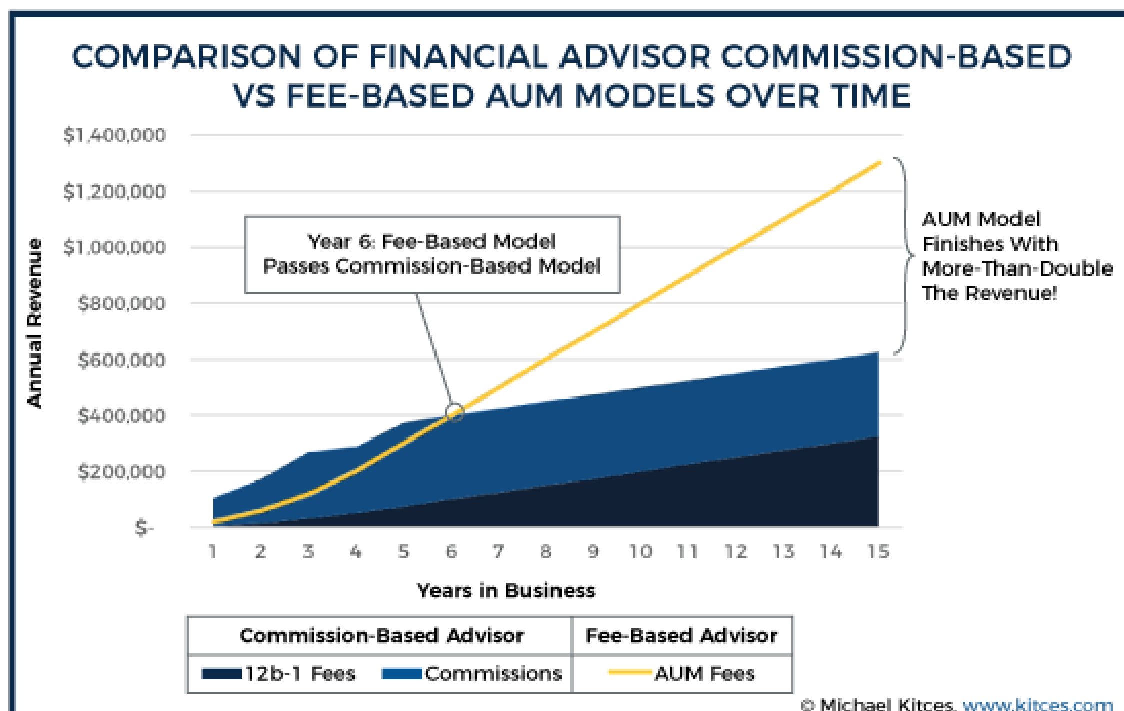
Fee-based advisory business that pays an ongoing assets-under-management (AUM) fee, is a fundamentally different business. Getting paid an ongoing 1% (or some other) advisory fee is not a transactional business model; it's a recurring revenue business model.

For many people starting out, that's a huge challenge, because it takes even longer just to reach a point of financial breakeven. After all, if you're using A-share mutual funds, getting a $100,000 rollover may pay you as much as $4,000 in just a week or two (assuming a 4% commission breakpoint). Whereas with an advisory account, the first payment may not come for 2-3 months (at the end of the quarter), when you'll receive just $250 – the first quarterly billing of a 1% AUM fee. It's hard to build a business earning just 1/16th of the upfront revenue when a new client comes on board!

However, the compounding effect over time is very different. For instance, imagine two advisors who start at the same time. They both manage to gather $2M in assets their first year, $4M in the second, $6M in the 3rd, $8M in the 4th, and $10M in the 5th, as they steadily refine their prospecting, sales process, and value proposition to get bigger and bigger clients over time.

The commission-based advisor averages 5% in commissions in the first year, but drops to 4% in year 2, and 3% by year 4, as the bigger clients coming onboard hit higher breakpoints. (We'll also assume a 0.25% ongoing 12b-1 fee.) By contrast, the fee-based advisor generates just a steady 1% AUM fee on the cumulative assets under management.

As the chart below reveals, over the first five years, the fee-based advisor is behind – substantially so in the early years, and somewhat less as the asset base grows. However, by year 6, the two are equal to each other, as AUM fees on the cumulative asset base catches up to the upfront commissions (plus 12b-1 trails) on new business. By year 10, though, the fee-based advisor is earning 50% more. By year 15, the fee-based advisor has more-than-doubled the income of the commission-based advisor (and more-than-quadrupled when comparing fees to commissions alone, without 12b-1 trails!).



Notably, if at any point both advisors stop trying to bring in new clients, the fee-based advisor's income also still continues, while the commission-based advisor's income will drop precipitously (if relying on *only* the 12b-1 fees). On the other hand, the caveat is that the fee-based advisor had better be doing some ongoing *work* to validate that ongoing AUM fee as well, and support the growth of the practice. But the good news is that it's actually quite feasible to provide deepening ongoing client service, because the recurring revenue makes it "safe" to hire staff to support and service those clients!

After all, by year 6 the advisor is generating $400,000 of gross revenue. Which means the advisor could hire another advisor for $80,000/year, just to give great ongoing service to the *existing* clients. Notably, that advisor would have no business development responsibilities. Just an expectation to provide valuable financial planning advice, great service, and whatever else it takes to retain and serve the clients well. Because every year the clients stay on board, they're paying $400,000 of fees, and the advisor who services them is paid just $80,000 to do so. Which to say the least is a very "healthy" gross profit margin with $320,000 of net profit after the cost of the servicing advisor!

Of course, the reality is that most advisors wouldn't be able to keep the whole gross profit. There may be a cut for the broker-dealer (if you use one), and some staff overhead. But the fundamental point remains: now it's a real business, with a recurring profit, that is not purely dependent on the advisor/owner to keep selling to new clients to generate income!

The key point is the recognition that it costs far more to *get* a client than it does to *keep* a client. That's why, over time, it's feasible to hire advisors to *serve* existing clients, and still have a profit left over, with ongoing AUM fees. And as the business grows, it's feasible to reinvest even *more* into what clients are provided, further improving retention, attracting larger clients, and making the endeavor even more profitable!

AUM advisors grow bigger than others b/c it's less expensive to service clients than to get them!
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Transitioning From Commissions To A Fee-Based Business Model

Unfortunately, the incredibly low initial revenue when building a fee-based business from scratch is not feasible for many advisors; even those who in the long run hope to transition to advisory fees may still do some commission-based business to fill the "income gap" in the early years.

Nonetheless, at some point when the advisor is established, and there's a steady stream of prospective new clients and referrals, it becomes far easier to transition to a fee-based business model, even for those who started out more commission-based and transactionally oriented.

Become A Dual-Registered Or Hybrid Series 65 Advisor

To make the fee-based transition, the starting point is to become eligible to do fee-based business, which means either becoming an Investment Adviser Representative (IAR) of your corporate RIA (known as being "dual-registered"), or forming your own outside RIA (known as being a "hybrid"). Which is more appealing depends on the capabilities of your broker-dealer's corporate RIA solution, and whether they'll even permit you to have an outside RIA as an Outside Business Activity (OBA).

In order to begin doing advisory business – whether under the broker-dealer's corporate RIA, or your own – it's necessary to have the Series 65 license. Those who originally did their Series 66 along with their Series 7 are already covered (as technically the Series 66 is a combination of the Series 63 and the Series 65). For those who originally "just" did their Series 6 and Series 63 exams, though, it's necessary to register and sit for the Series 65 exam. Fortunately, there are a lot of Series 65 exam prep solutions available to help.

Standardize Your Investment Process

A key issue in converting your business to fee-based advisory accounts is that clients expect that you'll actually *do* something on an ongoing basis to earn that advisory fee. And if the clients don't hold you accountable, then regulators will, as both the SEC and FINRA have raised growing concerns about how advisors are deciding when/whether to steer clients to commission-based or advisory accounts, and in particular whether otherwise-low-maintenance clients are being subjected to "reverse churning" (where a client is placed in an advisory account but the advisor does nothing ongoing to earn the ongoing fee).

Notably, this doesn't necessarily mean that you have to actively manage the accounts yourself (though clearly that's one option). You could decide to use third-party managers or separately managed accounts, or have discretion to manage the account directly and hold predominantly passive investments. But at a minimum, regulators will expect that you can demonstrate a process of *ongoing monitoring* of client investments – including both reviewing the accounts themselves, and periodically meeting with the clients – to substantiate the ongoing fee.

However, the process of monitoring, and having (more) regular client meetings, can become very challenging when every client holds different investments. In a transactional world, it was/is sufficient to simply sell an investment, and when the client happens to meet with you again, pull some fresh Morningstar reports and see if there's anything that is worth changing or replacing. In the context of a fee-based advisory account, though, the process should be more systematized. Which means using a consistent set of investment solutions, or perhaps a series of models (with varying degrees of equity exposure), so that the process of monitoring the investments means you just have to monitor a common set

of investments once, and not re-research every holding of every client leading up to every meeting! Otherwise, as the number of advisory clients grows, the "busy work" leading up to each client meeting becomes unbearable.

Expand Financial Planning Services As Well?

In today's environment, a process of ongoing investment management – or at least, ongoing investment monitoring – is effectively a minimum standard for charging an advisory fee. The challenge, however, is that "robo-advisors" are already capable of doing the same thing, while charging far less than the typical advisor.

Which means adding enough value to charge an advisory fee is increasingly about doing more than *just* creating a diversified asset-allocated portfolio and monitoring it, because that service is becoming commoditized. Instead, advisory firms are now faced with providing more and more personal financial planning advice, to help bolster their value proposition and justify their advisory fees.

For an advisor who has historically been primarily focused on commissions, this means it will likely be necessary to pursue your CFP certification (or if you already have it, consider a post-CFP designation) and expand your advice knowledge beyond your current product set. Or alternatively, at a minimum, it means going out to hire paraplanner support, or even full CFP professionals to be service advisors, to provide that additional advice value-add.

In turn, those deeper financial planning capabilities must then be packaged into a financial planning solution for clients. That could be a commitment to do annual financial plans or updated retirement projections for every client, being available throughout the year to answer their ongoing financial planning questions, or even the development of an entire annual client service calendar of financial planning value-adds.

Simply put, if you're going to transition to fee-based advisory accounts, be prepared to demonstrate what value you will provide *beyond* what a robo-advisor, or a solution like Vanguard Personal Advisor Services or Schwab Intelligent Advisory, can already do for 28-30bps.

Making the Gradual (Income) Shift To Fee-Based Business

One of the biggest challenges in making the transition to fee-based advisory business is that, even as a relatively established advisor, it will likely feel like taking one step backward in order to take two steps forward. After all, the reality remains that ongoing advisory fees generate less income in the first year, and far less income in the next quarter, than commission-based business, even if there's a favorable crossover a year years down the line.

As a result, the transition from commission-based to fee-based business is often done gradually over a span of several years.

The starting point is to more carefully consider each new client that comes on board, and whether they're a good fit for the fee-based model. The key determinant should be whether it's a client who wants and needs ongoing portfolio management and ongoing financial advice, and has the potential to be a long-term fit for the firm. If some new clients go fee-based and others are still commission-based, the income transition is not as "traumatic" as switching all new business at once.

Similarly, transitioning *existing* clients to fee-based accounts is also something that should be done gradually. The starting point is simply to make a list of clients, and identify the ones who have ongoing needs, for whom an ongoing advisory account might be a good fit. Then, aim to raise the issue at their next (annual?) review meeting.

When transitioning clients, it's usually not enough to simply state that you're now switching them to a new type of investment account/solution that has an ongoing fee; clients who are not used to paying an ongoing fee will (rightly) ask what the benefit is to making the shift now. As a result, the easiest way to make the transition is to position it as an entirely new service solution, for which you're making a "new" sale to an existing client who happens to be a very warm prospect (since they've already done business with you in the past!). For instance, you might say:

> [Mr. and Mrs. Client],
>
> We've been working together for several years now, and I'm excited to share with you that we're rolling out an entirely new service, that I think will be a great fit for you.
>
> With a new Managed Account solution through our [broker-dealer] platform, we now have access to new high quality investment solutions to meet your retirement goals, and I'd like to transition you into one that I think is a particularly good fit for you. [Share some additional information about their investment process.]
>
> Making the shift will have no upfront commission cost to you. Instead, we'll simply be paid a small ongoing advisory fee in the future, for our role in helping you to manage and monitor the investment portfolio. In addition, for clients who choose our new advisory solution, we'll also be providing ongoing annual financial planning updates to ensure that your portfolio is on track to meet your goals, at no additional cost. And we're hiring a new CFP professional to add to the team, just to help answer any additional financial planning questions you may have.
>
> To move forward, we've already done a review of your existing account for the potential tax consequences of making this transition, and would like to go over those details with you now…

Of course, the reality is that not every client will want to shift to an ongoing advisory service, nor will it be right *to* shift every client. As noted earlier, regulators are increasingly scrutinizing whether advisors are appropriately steering clients to commission- vs fee-based accounts, and clients who don't have ongoing investment or advice needs shouldn't be in an ongoing advisory account. In the long run, you'll have to decide whether it's worth continuing to support those clients at all, though, if they don't fit your service model in the future, or if it's more appealing to simply transition them to another advisor (or even engage in a partial sale of the business for that portion of your client base).

Even with a gradual transition, though, it will still be necessary to prepare for the revenue impact of transitioning clients to fee-based advisory accounts. While it may lead to a more stable and profitable business in the long run, it can still take 3-5 years of ongoing advisory fees to make up the lack of upfront commission revenue. Which means being certain not to transition "too quickly" and creating a cash flow crunch for yourself.

Advisors shifting from commissions to AUM may want to plan the transition over time!
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Nonetheless, in the long run, the rapid growth of the RIA channel makes it clear that fee-based advisory relationships can actually produce a much larger and more stable advisory business (not to mention one that gets far better valuation multiples!), thanks to the nature of a recurring revenue business that allows for a more stable staff infrastructure to give clients more and deeper ongoing service. Not to mention that in practice, transitioning to advisory accounts better aligns the business to where the winds of regulatory change are blowing anyway; after all, investment commissions have already been banned in the UK and Australia in recent years, and while the DoL fiduciary rules didn't outright ban commissions, the streamlined compliance rules for operating as a Level Fee Fiduciary (using advisory accounts) means most of the industry here in the US may end up there any way in the coming decade. Which means the sooner you transition, the more prepared you'll be for the regulatory future to come!

So what do you think? Is the fee-based AUM model more profitable over time? Have you been considering transitioning to a fee-based model? Has DoL fiduciary influenced your decision to be commission-based or fee-based? Please share your thoughts in the comments below!