fair fee
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Guide

Fixing The Broken Model

The search for a fairer way to pay for wealth management

Contents

Fixing the broken wealth management fee model:

Paying for what you don't get. How investors can be receiving confused and conflicted advice, often paying too much for it – and what to do to fix the problem.

Pages

Introduction

Why do you save and invest money today instead of spending it?

For most people, it's to provide for their future, their family's security and to ensure that their living standards are maintained during their retirement years. It seems like the right and responsible thing to do.

Professional investing isn't what the majority of people do for a living, and so outsourcing the task to experts feels like a natural choice.

However, there is a significant problem that most people are blissfully unaware of. Most wealth managers charge a percentage of the money invested, typically around the 1% level.

This looks like a small and inconsequential number, but the long-term effect on investors' future wealth can be huge.

"The percentage-based advice fee model is a busted flush and is unsustainable, unfair and can lead to a conflict of interests." **- Jason Butler, Financial Times**

Here's an example

An investment of £1 million, over a 30 year period could mean the investor ends up with £1 million less, due to the effect of a typical percentage fee structure, when compared with an alternative flat fee model.

So, in effect the same amount as the initial investment is lost in wealth manager's fees.

That's £1 million less to support retirement plans, for family, friends and good causes.

It's worth paying attention to these numbers, they can be life-changing amounts of money.

What's the problem?

The percentage fee model

The problem is that the percentage fee, based on the value of the money invested, transfers too much money from your life savings into the coffers of the wealth manager.

A secondary problem is that the fee you pay is not always equal to the service you receive in return.

The wealth management advice fee of 1% a year or thereabouts (the percentage may vary), is often well documented and hidden in plain sight.

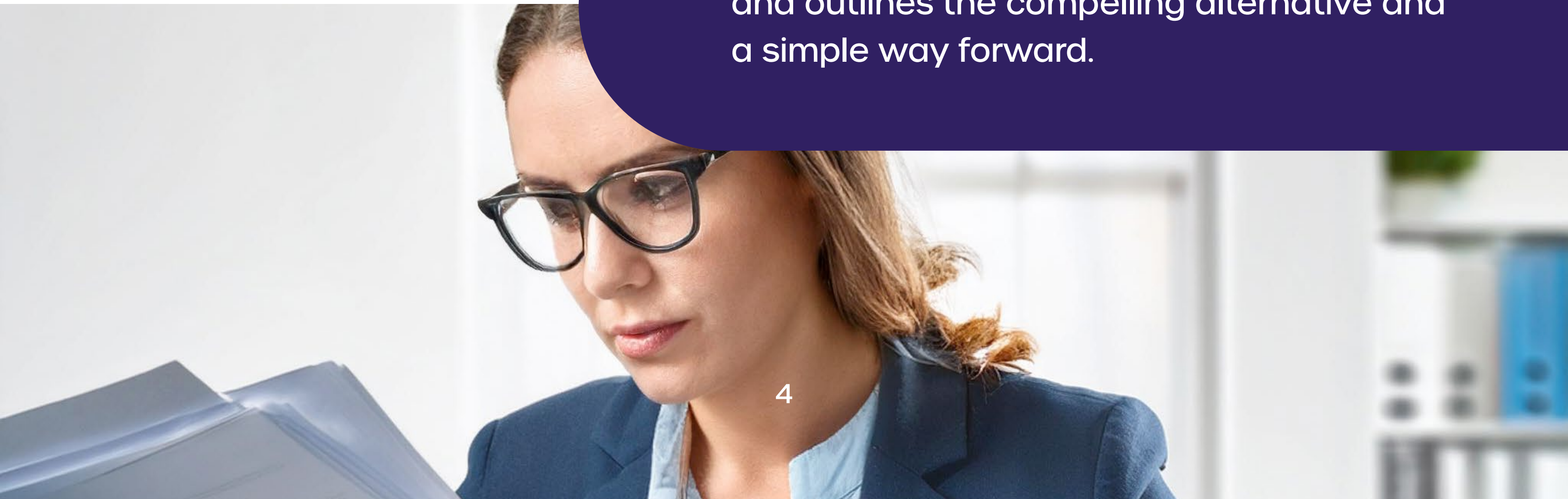
Over a lifetime of investing, this percentage fee eats away at the money being invested (the portfolio) but the real consequence is rarely seen, known or understood by the investor.

Wealth managers are aware of the percentage fee model and how it favours their employees and shareholders but have been keen to maintain a low profile and keep any discussions off the public radar. We believe that there is a problem with this method of charging for wealth management advice. It has the potential to create a conflict of interest and possibly a cross subsidy where some clients pay more than their fair share of fees based on the service they receive.

These factors are a threat to the core requirements that you seek: impartial advice and wise counsel on your investments and personal goals.

Simply put, the percentage model is broken and needs to be fixed for the benefit of your and your family.

This guide explains what these problems are and outlines the compelling alternative and a simple way forward.



Key issues: A summary

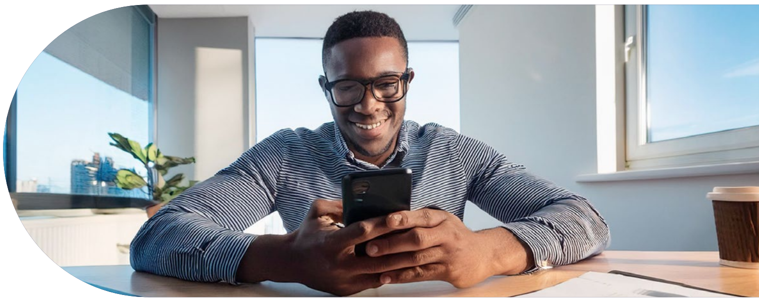
The main problems with the percentage charging model

There are numerous challenges created by the dominant fee model, one which is based upon a percentage of the money invested. These are the most important:

01
Cost

The compound effect of a percentage fee of your money can be very significant, particularly with larger portfolios over longer periods of time. With many couples now experiencing two-person retirements lasting 30 years or more, the percentage fees charged by wealth managers can create a very costly drag on returns.

This, in turn creates a negative effect on the eventual outcome. The consequence of these costs is not trivial and can make a real difference to the success of your retirement plans and investment goals.



02
Cross Subsidy

In simple terms, the more money invested, the greater the fees paid to the wealth manager. According to a survey by the consumer group Which? On average the annual fee is 1% of the money invested.

Rates will vary across firms.

This could mean that a client with a £1m portfolio is paying £10,000 each year in fees and the client with £100,000 invested pays only £1,000, often for a similar level of service. This isn't fair or reasonable, as some clients are being disadvantaged and are often overpaying for the services they receive.

Key issues: A summary

03
Conflict of interest

On a percentage-based fee model, the wealth manager may receive an immediate pay cut in their fee income if money is removed from the invested portfolio.

So, typical lifestyle events such as making gifts to children, buying property or investing in a business could lead to a reduction in the manager's fee revenue. As a result, there may be some resistance from the wealth manager to support a recommendation to sell assets within the portfolio.

Other suggestions may often be made to preserve the portfolio value and the ongoing fee income.

04
Contingent charging

By linking wealth management fees directly to a percentage of the money invested, the wealth manager will be paid only if you invest money.

No investment means no fees.

Alternatives such as paying off debt or keeping a healthy cash buffer may be overlooked, as such options would not generate fee income for the wealth manager.

The regulator, the Financial Conduct Authority, has expressed concerns over contingent charging and the need for wealth managers to sell investments in order to be remunerated.

Methods

This guide puts forward the view that wealth management firms should adopt the methods used by legal and accounting firms to charge for professional services.

By doing so, a more relevant, fair and transparent approach will emerge for the benefit of the investing public, as well as the wealth management industry.

The industry will be seen as more trustworthy and better positioned to ensure good client outcomes, fully aligned to the services being delivered for the fee being charged.

What services are investors actually paying for?

The first question investors should ask when engaging with a wealth manager is: What services are we actually paying for?

If the answer is 'advice' (and after all that's what the majority of people seek), then the advice is a function of the expertise of the wealth management team, the level of complexity of the advice required, and the time taken to provide that advice. None of these factors is necessarily related to the amount of money being managed for the investor.

Someone with a modest amount of money to invest could have circumstances that require a significant level of advice about how to manage their financial affairs.

On the other hand, a wealthy individual with relatively simple arrangements might need only modest amounts of ongoing advice and support.

"Do the wealthier clients think they get as much as 10 times the face-to-face time, research and reports?"
- Paul Lewis, Journalist/Presenter of Radio 4 Moneybox

There is a flaw here because in the percentage model even if the service selected is simply to manage investments, there isn't a direct cost relationship between managing, say £100,000 and £1m.

The point is that it doesn't cost the wealth management firm ten times as much to manage £1m and yet the fees charged may be10 times greater.

The importance of a clear and fair fee model

Examples from outside the financial industry:

A person has been referred by their GP to a Harley Street consultant for an important operation that they have agreed to pay for privately.

The consultant has all of their medical history, explains the procedures in great detail, discusses the risks carefully as well as the aimed for ideal outcome, and how the patient's health and lifestyle is likely to be improved. The patient feels relaxed and confident and is keen to proceed.

The consultant talks about the cost of the operation and associated factors, and then asks the patient what they are worth – their investment portfolio, pension fund, property, ISAs and the value of their home. The patient asks why this information is relevant to the operation. The consultant replies that the operation is costed based on a percentage of the accumulated wealth of each patient. The more the patient has saved or inherited, the larger the fee for the procedure.

How do you think they would feel? Confused? Disappointed? Angry? What relevance is their wealth to the delivery of this professional service?

The percentage fee model is alive and well in the field of estate agency and surveys reveal that estate agents rank low in the zone of public trust.

When people get a very similar level of service, yet are charged based on the value they bring rather than the value they get, and pay differently as a result, it is time to question whether this is a fair and clear fee model.

Other examples which illustrate the unusual nature of this percentage fee model, could be applied to some everyday events:

- Booking the same holiday resort
- Dining in the same restaurant
- Having your car serviced

The advisory relationship

A second and equally important question for investors to ask is this: is the advisory relationship with you and your family or is it with your money?

The resounding answer, if you were to ask your wealth manager, would be that the relationship is personal and not financial. Some investor-manager relationships may have lasted for years.

If manager pay and reward is linked to the value of the invested assets, then it's difficult to put the two elements together.

If all you require from your wealth manager is a selection of company shares and government bonds, plus an annual valuation and report - then alternative low-cost models exist at a fraction of the price.

For those people who value human contact and discussions focussed on planning, future lifestyle needs, income and tax planning, gifting, education funding, long-term care, property assets, estate planning, among others - it appears perverse that the fee charged is simply linked to the value of money being invested.

The percentage fee surges when markets rise and plunges when markets fall. Your need for an advice service does not rise and fall in line with the markets.

The best advice has little to do with the amount being invested. Where is the sense in that?

The advisory relationship

Good advice may include:

01 Financial coaching.

02 Providing wise counsel.

03 Getting financially organised.

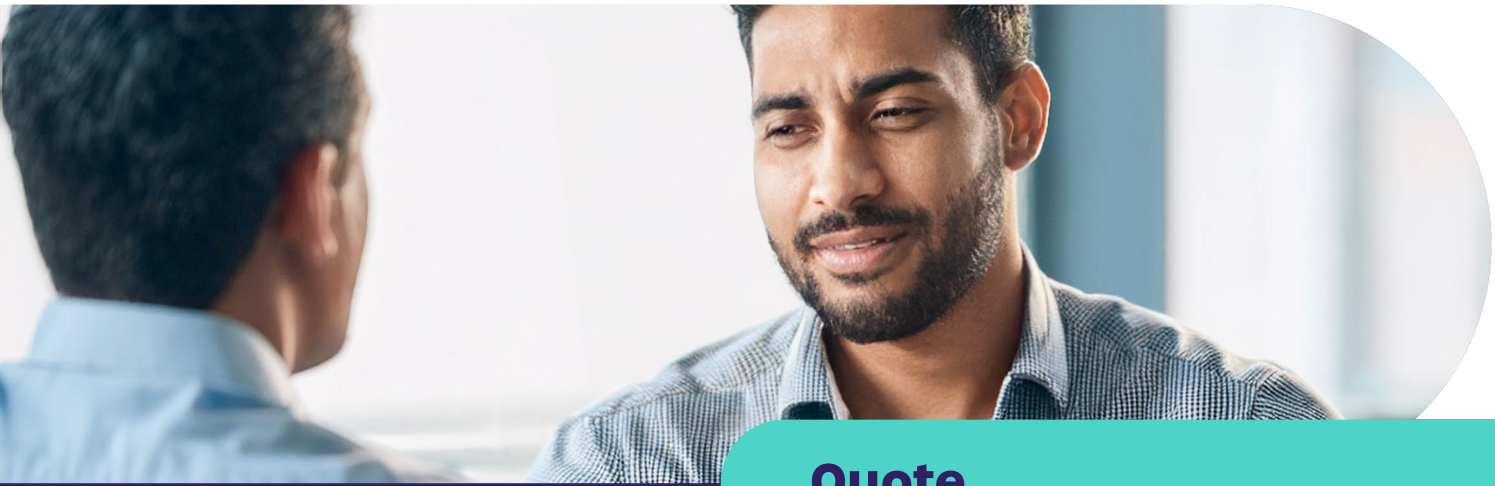
04 Help with legal and estate planning.

05 Helping children get on the property ladder.

06 Acting as an impartial sounding board for the client's ideas and concepts.

07 Providing a professional second opinion before major decisions are made.

08 Making plans for the future.



Quote

09 Helping to make complex circumstances much more understandable.

10 Using technical expertise to solve problems.

11 Guiding investors 'off the ledge' of making poor life and investing decisions.

12 Simply being there to listen objectively.

13 Retirement coaching.

"The traditional 'percentage of assets' model means that the client is compensating their financial provider for the value they bring rather than the value they receive. They want more control and transparency by engaging with fee structures that more closely reflect their engagement with their financial provider. "

- Sebastian Dovey, CEO of the Scorpio Partnership

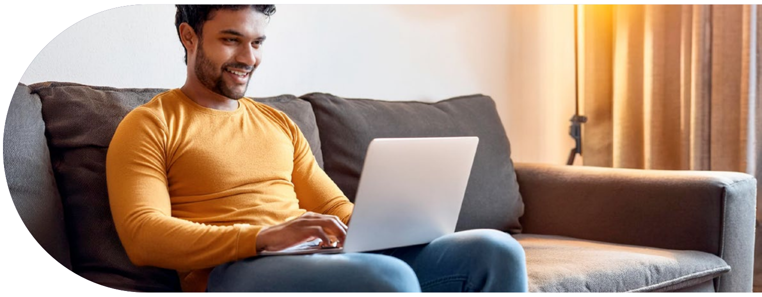
Why does the current model still persist?

The current model of charging exists today due to powerful vested interests that don't want change.

Think back in time to the tobacco lobby, and more recently to the fast food lobby. Big Business doesn't want change. Even major global car manufacturers are sticking to 19th Century engineering instead of embracing electric and battery power.

The same goes for the investment and wealth management lobby that extract huge profits at the expense of the private investor. This very powerful group are resistant to change and innovation when it comes to reviewing methods of charging clients for wealth management services, preferring to cling to a model which was first introduced almost 100 years ago.

We believe the time is right to challenge existing vested interests as is happening in other industries.



Indeed, several global businesses in fields as varied as music, travel and car hire stand out as examples of a change in direction. They all decided that there was a better way for consumers, one which created choice, clarity and attractive alternatives. The digital revolution has democratized services and choice, bringing with it new ideas, new thinking and innovation.

Our focus is on the subject of wealth manager services, how they are delivered and how they are paid for.

"It is difficult to get a man to understand something when his salary depends upon his not understanding it."
- Upton Sinclair, Author

The four C's quandary for every investor

The main challenges of the percentage fee model can be summarised under four key headings: Cost, conflict of interest, cross-subsidy, and contingent charging.

01 Cost

The mental arithmetic issue

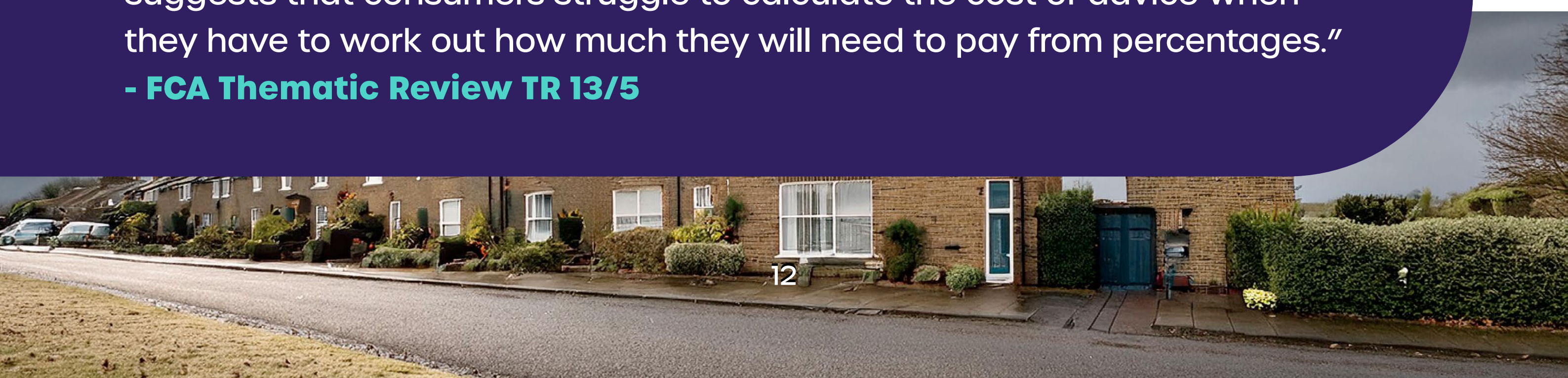
In general terms, it isn't easy to mentally calculate fractions or percentages of large complex numbers. The Financial Conduct Authority (FCA) has warned that percentage charging has left some clients struggling to calculate the cost of advice.

Simple and elegant should always beat complexity. However in the world of investment; fees and charges can be highly complex. But surely, an annual fee of about 1% seems like such a small number, so why would investors get overly concerned by it?

We believe that clarity where costs are concerned is extremely important. To put the above future loss of £1 million into perspective, in today's money, adjusted for inflation, it is worth about £550,000.

That could buy your children two homes in the UK at the average price or could fund eight years in a high quality residential nursing home for a loved family member. As we said, life changing sums of money.

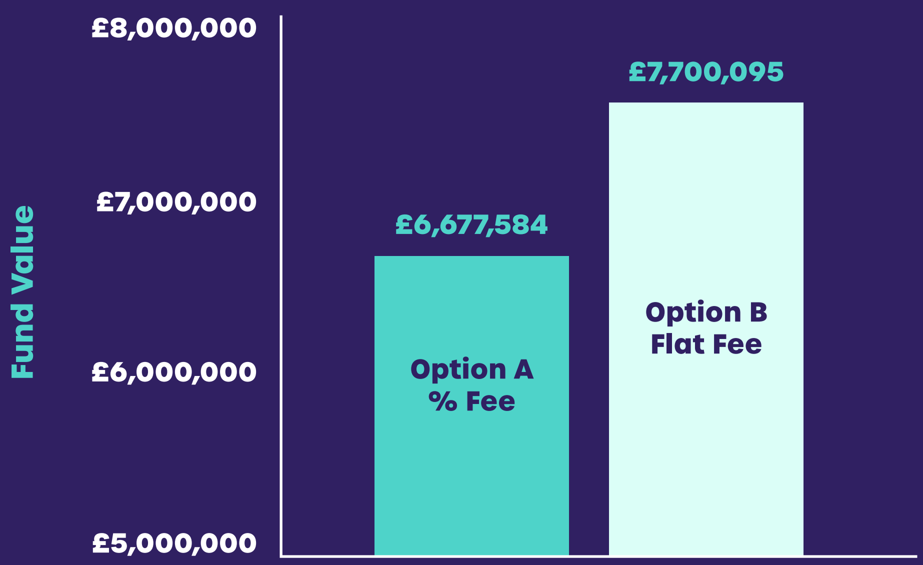
"Consumer research suggests that providing examples of adviser charging in pounds and pence significantly helps consumer understanding. It also suggests that consumers struggle to calculate the cost of advice when they have to work out how much they will need to pay from percentages."
- FCA Thematic Review TR 13/5



The four C's quandary for every investor

01 Cost

To illustrate the point, the example below highlights an alternative flat fee charging model.



Percentage fee vs. Flat fee fund value after 30 years

Option A is the 1% version and option B is the flat-fee-for-service alternative version.

A lump sum of £1m invested over 30 years at an annual growth rate of 7.6%. The percentage fee of 1% starts at £10,000 and moves in line with the portfolio value. The flat fee also starts at £10,000 and increases at the long-term inflation target for the UK (2%), adjusted every three years.

After 30 years what is the difference in value based on these two charging methods alone?

The investor selecting option A would have £1,000,000 less than the investor opting for option B. That is clearly a vast sum of money which the investor has overpaid and transferred from their own family's wealth to that of their wealth manager.

The four C's quandary for every investor

02 Conflict of interest

The gifting and spending conflict

For those with sufficient wealth, it can make sense to gift some of it away (to family, friends, and charity). Yet the percentage-charging model acts as a potential disincentive to the wealth manager.

When money is withdrawn from a portfolio, in many cases the wealth manager fee will be cut. Research confirms that incentives matter and despite all the best intentions, it's clear that when pay and reward is involved, there may be doubt about its influence on the advice provided.

The property purchase conflict

The property-buying scenario is a challenge for many families. Whether to buy a holiday home or help a child or grandchild onto the property ladder.

Buying property means either cashing in part of a portfolio or not investing the money in the first place. In both cases the percentage-charging model may act as a deterrent to good impartial advice.

Indeed, many wealth managers offer clients a service allowing them to borrow money to fund such purchases, rather than encourage the client to sell assets and therefore experience a cut in their fee.

The link to money under management and the reward structure is an extremely strong motivational force. Unfortunately, it simply isn't always aligned to the needs of the client.

"Motivated blindness is when you don't recognise facts that are sitting in front of you because they would be inconvenient for you to recognise."
- Scott Killingsworth Senior Counsel, Bryan Cave LLP

The four C's quandary for every investor

02 Conflict of interest

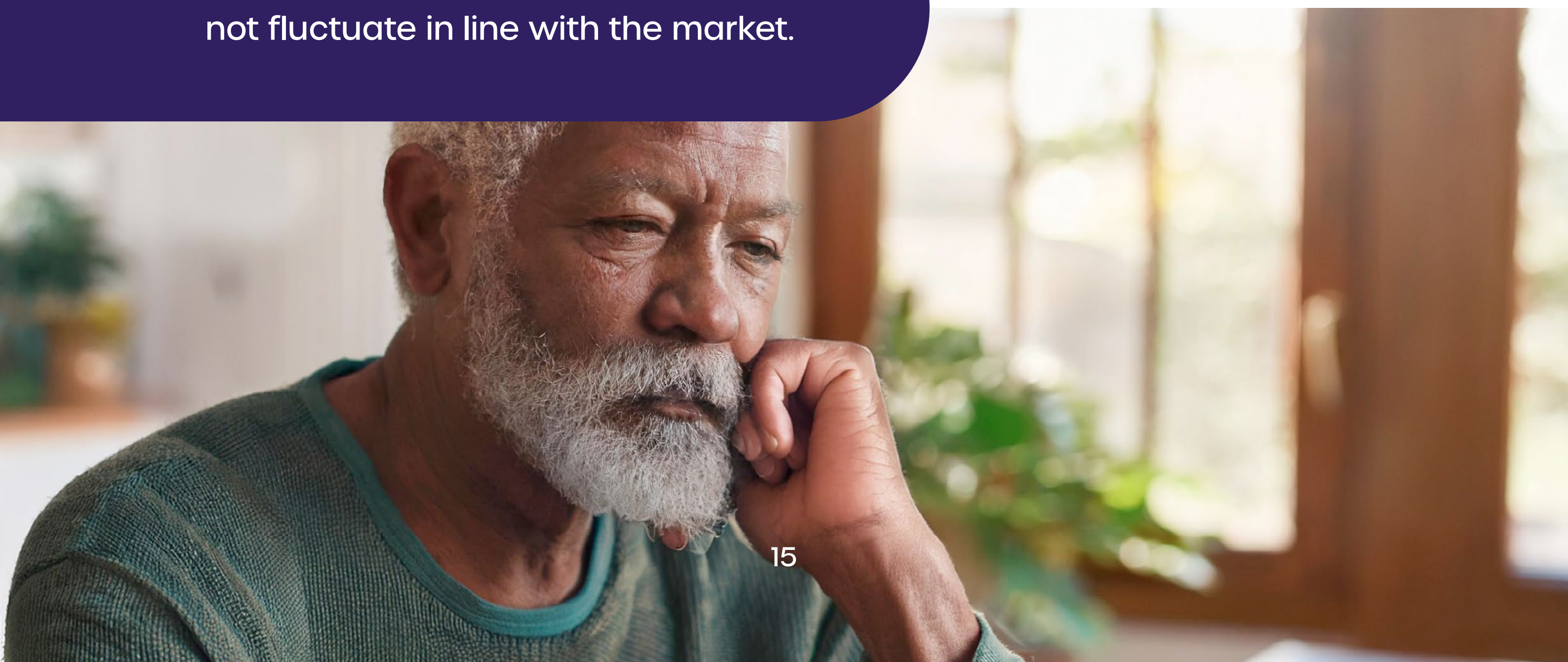
A client invests their inheritance with a wealth manager on a percentage fee basis. The global economy performs very well and after 10 years has doubled in value.

Both the investor and wealth manager are very happy (bear in mind that the percentage fee means that the fees paid have also doubled).

After the 10 year point, the client wants to make some significant gifts to their family. Their daughter is about to marry so they request a capital withdrawal from the portfolio to fund the cost in full.

Unfortunately, the global investment markets begin to fall, dragging down the percentage based fee linked to the portfolio.

The need for quality advice does not fluctuate in line with the market.



The four C's quandary for every investor

02 Conflict of interest

A year later a request for a further withdrawal to fund the property purchase for their son is made.

By the end of year 12 the portfolio is now 45% below its former peak and the client is beginning to ask questions about their ability to retire early and is expressing concern over the value and sustainability of the investments. At the same time, the wealth manager has seen their fee fall by 45% in line with the portfolio value.

Whilst advice from the wealth manager didn't stop completely during these 12 years, incentives do matter and can influence behaviour.

When money is withdrawn from a portfolio the wealth manager may lose interest and as a result, advice could falter. In the context of a service relationship based on trust, this faltering advice should be a big concern for any investor.

The need for advice is determined by the unique personal circumstances of each client and not the value of the investment portfolio.

"There are many situations in asset management, a business that owes a duty of fiduciary care to its investors, where the desire to maximise profits for shareholders can come into conflict with the best interests of investors. This conflict is the Achilles' heel of the finance industry." **- Paul Smith, President and Chief Executive of the CFA Institute Counsel**

The four C's quandary for every investor

03 Cross-subsidy

A wealth management business will often generate an annual profit, but if the company data is examined closely the business could find that some of their clients were actually unprofitable to service, while other 'larger' clients produced a 'super profit' based on the service delivered and the time consumed.

We recognise that the cross-subsidy is not restricted to the percentage model and can apply to all wealth management businesses, but we do think that the percentage based fee makes this cross-subsidy more likely.

Mike has an investment portfolio of £100,000 and his friend Sue has a portfolio of £1,000,000.

They each have the same wealth manager and get similar quarterly updates and one annual meeting. They are both charged 1% of their investment value. Mike pays £1,000 and Sue pays £10,000.

Is this fair on the clients who invest the most money? How would they react if they knew?

The fact is that the wealthier clients are more likely to be paying too much in wealth management charges under the percentage model for the services they receive in return, even if the percentage fee reduces on a sliding scale for larger sums invested.

"The business of investment advice is a strange one. The leading model of advisor fees results in high net worth investors paying high fees simply based on their ability to pay, and not related to the services they receive." **- James Osborne, Bason Asset Management**

The four C's quandary for every investor

04 Contingent charging

The Financial Conduct Authority (FCA) has expressed concerns that where the primary method of wealth manager remuneration is dependent on financial products or investments being purchased, there is likely to be a disproportionate level of advice to purchase such products rather than, for example pay off debt which is often sound advice. This is effectively the 'no win no fee' business model.

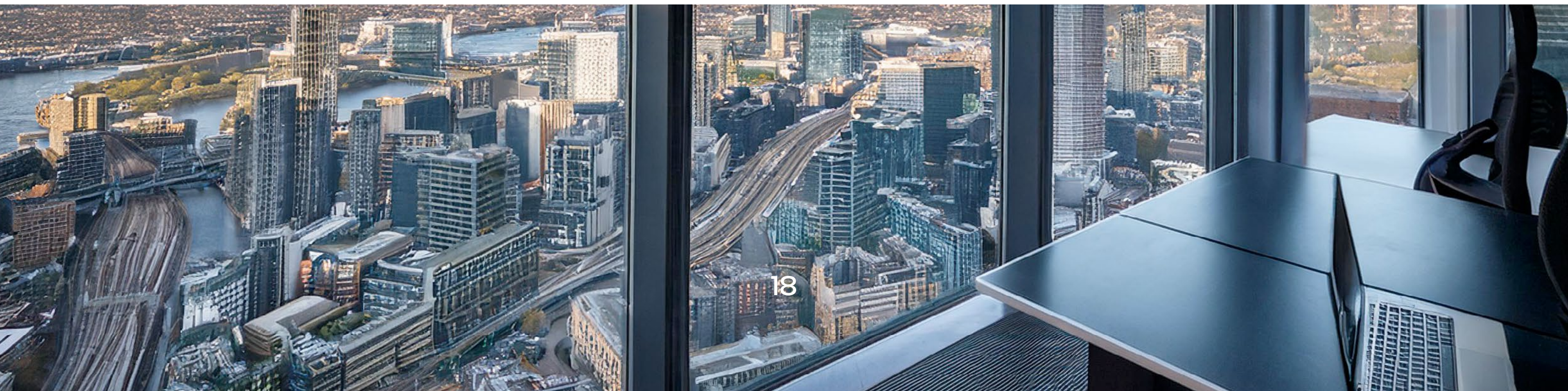
"Never ask a barber if you need a haircut." **- Warren Buffett**

Should investors have to face the confusion and doubt that they are going to be 'sold to' when they meet their wealth manager? We don't believe that they should.

Here is what the regulator had to say:

"In some cases, firms are charging a percentage of product investment, and clearly it takes away product bias in the sense that we are no longer seeing firms recommending particular products because of the payment that comes to them but it does not take away dealing bias because if you only get paid if people buy a product, then you are going to want them to buy a product rather than pay off debts or do something else."

- Martin Wheatley, CEO of the Financial Conduct Authority



The way forward

Investors using wealth management firms should raise the points discussed in this guide.

They should be asking questions such as:

01 What are the total fees we pay you each year to manage our money in pounds and percentage terms?

02 Can you show me the service schedule that I get for my fee? Simply put, what do I get for the fee you charge me?

03 Is this service schedule different for other clients of your firm? If yes, please explain the differences to me.

04 Why do you charge on a percentage basis? Is this in my best interests and aligned to my personal goals?

05 Do wealthier investors of your firm pay more for broadly the same service as those with smaller portfolios?

06 Is there a conflict of interest where the fee revenue you receive is directly linked to the value of the money you manage for me?

07 Can you offer a flat annual fee model rather than the percentage fee currently charged?

08 If so, what would the annual fee be in pounds and what services would I get for that?

A better alternative

If the answers to these questions don't provide robust clarity and reassurance, then for some private investors, there will be a clear desire to move to a better alternative. One that puts their interests first and not designed for the benefit of their wealth manager.

Changing an adviser or wealth manager is a very simple process and we expect to see many people, now aware of the challenges presented in this guide, to take action to protect their interests and that of their families.

Conclusion

The dominant method of charging for wealth management in the UK is overwhelmingly the percentage model.

Our contention is that this outdated and broken model is not aligned to the long-term interests of the clients, and the services delivered to them by wealth management firms.

There is a compelling alternative available which is easy to understand, fully transparent and linked precisely to the service being delivered and which is in the best interest of all parties.

This is preferable to the homogeneous 'one-size-fits-all' model, which doesn't really fit anyone well.

Investors will benefit from impartial professional advice and guidance, paid for in a modern and fair way, rather than remain with the outdated and broken percentage system.

Investors should new demand a fair and equitable method of paying for professional advice and services.

No confusion. No conflict of interest. No cross-subsidy.

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