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How Do Financial Advisors Earn Their Fee?

by David John Marotta

Most of our clients are frugal supersavers. Often they have accumulated their wealth not by earning more but by simply spending less. They are the millionaires next door living well below their means, which is why they have means.

Few investors even ask how commission-based annuity salespeople earn their fee, but with fee-only advisors the question often arises. Investment fees are generally about 1% of assets under management and drop as assets rise above $1 million. The critical question to ask is "Where do financial advisors add value that might exceed the 1% fee they charge?"

Here are five ways an investment manager might bring value to a portfolio.

1. "No, that's a bad idea."

We use eight principles to safeguard your investments. Many poor investment choices violate more than one of these safeguards. Clients ask regularly about putting their money in various investment options. The first time we say, "No, that's a bad idea," we might have just earned our fee for life. Given the greed and deceit in the world of financial services, this should not surprise you.

2. Lowered expense ratios

We build portfolios with expense ratios of about 0.38%. The average equity mutual fund charges an expense ratio closer to 1.38%. Specialty and international funds have higher averages.

Mutual fund expense ratios pay for the administration and active management talent that do not actually boost your returns. High expense ratios often include12b-1 advertising fees. These may even cover the commissions of agents who are selling those funds to you and posing as objective financial advisors. Fees matter, and the higher the fees the greater the hurdle of beating the index to justify those fees.

Even if the expense ratios of your funds are well below average, there may still be savings that can help pay the lion's share of what a fee-only advisor charges. With an investment advisor you get more than a collection of funds. You get the offer of comprehensive wealth management advice.

3. Regular rebalancing

Rebalancing your portfolio provides a rebalancing bonus. The exact amount is proportional to the lack of correlation between the asset classes and the volatility of the markets. Rebalancing can both reduce risk and boost returns. But you can't rebalance your portfolio if you don't have a target asset allocation to rebalance back to.

Crestmont Research studied the difference in returns between rebalancing every year versus every two years in varying types of markets. In secular bull markets, rebalancing less frequently had a slight 0.3% annualized advantage. But in secular bear markets, rebalancing more frequently had a more significant 1.3% advantage. Another study verified smaller gains for even more frequent quarterly and monthly rebalancing. And research on the Yale endowment attributed 1.6% of its annual portfolio returns to rebalancing.

Even an investment advisor who helps you set an appropriate target asset allocation and presses the rebalance button once a year might earn an additional 1.6% for your portfolio.

4. Staying the course

Even with a brilliant investment plan, it takes diligence to overcome our emotional biases and avoid making investing mistakes. A wise investment advisor can help clients overlook their natural loss aversion and stay the course.

Markets are always volatile. The more frequently you look at the markets, such as daily or weekly, the more discouraged you get. And even if you have a well-crafted investment strategy, you may be tempted to make changes to alleviate your suffering. Every study shows that loss aversion actually causes greater than average losses.

A Morningstar study found that investors experienced 1.5% less return than the average of the funds they were invested in, specifically because they moved out of the funds after they went down and back into them after they went up. In other words, there is a 1.5% bonus for not getting out after a drop and an additional 1.6% for rebalancing your portfolio and buying after drops.

5. Asset allocation strategy

Rebalancing assumes you have a target asset allocation in the first place, which is where an advisor's investment philosophy matters. Portfolio construction begins with the most basic allocation between investments that offers a greater chance of appreciation (stocks) and those that provide portfolio stability (bonds). Decisions at this level are the most important in determining how the behavior of your portfolio returns.

We use six different asset classes and a score of subsectors and categories. In each case we search for the optimum mix for long-term investing. Three asset classes are for stability: short money, U.S. bonds and foreign bonds. The other three asset classes are for appreciation: U.S. stocks, foreign stocks and hard asset stocks.

For U.S. stocks we set an optimum mix based on style and sector of the economy. On average, small cap outperforms large, and value outperforms growth. Returns between different styles can vary as much as 0.61% a month or 8.33% annually. Blending a portfolio allocation can make it even more efficient by either boosting returns or lowering volatility. And dynamically changing allocations based on forward-looking price-to-earning (P/E) ratios can boost returns by an additional 1.89%. There may also be times to overweight or underweight specific industries such as technology or health care.

In foreign stocks we overweight countries with economic freedom. We seek to underweight countries with high debt and deficit. These choices should outperform the MSCI EAFE index of foreign stocks, historically as high as 5.56% annually. We also include emerging market equities. We also tilt value and include small cap stocks.

The appreciating third asset class is hard asset stocks. These hard asset investments include companies that own and produce an underlying natural resource. Examples of these resources include oil, natural gas, precious metals (particularly gold and silver), base metals such as copper and nickel, and other resources such as diamonds, coal, lumber and even water.

We segment these hard asset stocks into their own asset class because they have a unique set of characteristics. First, the movement of hard asset stocks is generally less correlated with the movement of other asset classes such as bonds. Second, hard assets have a unique (and positive) reaction to inflationary pressures. And third, at certain periods in the longer term economic cycle, including hard assets helps boost returns.

Gains on specific asset classes affect only a portion of total investment returns. And in each case the possible boost in returns has to be high enough to justify the added expense of crafting a portfolio to overweight that investment choice.

None of these methods of boosting returns are secrets. I write about them every week in this column. But they do take time and effort to plan, implement and monitor. You can take the time yourself, or you can find a competent wealth manager who will act in your best interest and do what you would do if you had the time and expertise.

Investment management is at the core of wealth management. These are some of the ways in which a fee-only financial advisor might earn their fee on investment management alone. If they did, all of the other wealth management services they offer are at no additional expense.

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