

# Worth



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### First Person: Industry View

#### The Costs of Counsel

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You recently decided to retain the services of a high-quality wealth management firm. This firm will offer advice and consultation on many aspects of your overall wealth plan: your investment portfolio, your cash flow and lifestyle planning, your estate planning, your wealth transfer and philanthropic endeavors, even private travel. You anticipate that this firm will offer you objective advice and assist you in being a good steward of your family's wealth.

You engaged in a rigorous due diligence process, interviewed several firms, thoroughly checked references and believe you finally found the firm that is the best fit for your family's unique financial situation.

Now comes the hard part: How do you determine how much to pay your new wealth management partner?

There are many ways to structure a compensation schedule for wealth management services, but the two most widely used are a fee based on a percentage of the assets under management (%-AUM) and a negotiated flat retainer fee.

**The key to all successful business partnerships is that both parties believe that fair value is being exchanged.**

Which is better? It depends. There are pros and cons to both approaches. The %-AUM method is (rightly or wrongly) somewhat of the industry standard, at least up to certain asset sizes. If, for example, you allocated \$10 million to a %-AUM-based wealth manager, your annual fee would be some agreed-upon percentage (e.g., 1 percent) of this amount. Note that this fee structure is a

function of your investable assets and not of your net worth, nor does it factor in the overall scope of services provided by the wealth manager. It is a clean and very easy to understand methodology, but it is subject to certain considerations.

When an advisor is strictly managing investments, the %-AUM approach is appropriate because there is a direct link between the fee and the service being provided. Specifically, you have given that asset manager money to invest, and the AUM—and thus the manager's fee—rises and falls in accordance with how well the manager performs. It becomes more problematic when the wealth manager is advising on multiple aspects of your wealth plan.

When a family is comparing two wealth managers, it may find wide discrepancies in the pricing. For example, an investor with \$10 million to invest might see quoted fees ranging from approximately 0.65 percent to approximately 1.5 percent, expressed as a %-AUM. This is usually because there is a fundamental difference in the service offering proposed by each firm. While those differences may be clear to the firms that compete in this business every day, they may be lost on the family, which typically generated its wealth in other arenas.

To paraphrase the old cliché, families often don't know what they don't know. More specifically, they don't know they need something until they need it. So it is not uncommon for the family to look at a higher-priced wealth manager that offers a broader array of services and think, "Well, we don't need all those other services, so why pay for them?" In some cases this is true, but many clients who are not committed to managing their investments themselves will eventually want to delegate most of the wealth management responsibility to an outside party so that they can focus on whatever it is that interests them. Also, while a family may not need a particular service now, it may find itself in need of that expertise in the future.

Another consideration of the %-AUM approach is the need for full transparency regarding the wealth manager's revenue model. A seemingly low %-AUM fee may simply be the loss leader to higher revenue business on products or transactions. For



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example, a wealth manager might charge a seemingly low advisory fee expressed as a %-AUM, which is being subsidized by fees from other sources—e.g., trading fees, custody fees or asset management fees on in-house captive products that are used within the client portfolio. This is fairly common at larger banks, brokerage firms and trust companies. As a steward of your family's wealth, you should know how your advisors make money; you may not be able to avoid all conflicts of interest, but you should certainly know when and where they exist.

One final issue to consider with the %-AUM approach is that if the wealth manager is, in fact, offering a wide variety of services in addition to investment advice, this type of fee structure may result (perhaps unconsciously) in too much focus on only the investment side of the offering. The dollar amount of the fee rises or falls with the performance of the portfolio, which can overshadow other real value the wealth manager may be adding in other areas. To use an extreme example, many wealth managers really earn their keep when the markets go down because they keep their client families disciplined and diversified, yet under the %-AUM approach their fee goes down!

Flat retainer fees don't really solve any of these problems, except perhaps the last. Flat fees, assuming they have been negotiated correctly, are usually preferable for the wealth manager because they allow more certainty with respect to budgeting and capital investment planning. They often make sense for the family, as well, because of the added certainty and the "unlinking" of the wealth manager's fee from investment performance, which removes any risk (small though it may be) that the wealth manager is taking more investment risk than is appropriate in an attempt to increase returns (and therefore fees). But this works only if the fee has been set appropriately.

The main issue with the flat-fee approach is the potential for "scope creep," a situation in which the parties agree to a flat fee based on an assumed level of service, but the needs or complexity of the family wealth plan grows past what was agreed to. In an increasingly competitive marketplace, many wealth managers find it difficult to go back to the family and raise the fee when this happens, and the result is an unprofitable relationship for the wealth manager. Contrary to what some families may think, a "good deal" that results in an unprofitable pricing model for the wealth manager is not in a family's long-term best interest. Families should want their wealth managers to be reasonably profitable; it is the only way they can continue to upgrade their service offering, make necessary capital investments and attract and retain high-quality professionals.

With the flat-fee approach, it is critical that the wealth manager have appropriate internal systems for tracking and calculating the actual cost of servicing clients. If these systems are not in place, then any discussion with the client regarding the profitability or viability of the relationship has no supporting evidence, and the family should rightly push back on any proposed fee increase. Clients should ask potential advisors about their systems before hiring one.

If the wealth manager can document sufficiently that the current fee arrangement is not profitable given the scope of service provided, and the family continues to want that level of service, then it should be amenable to an appropriate increase in fees.

As you sit down with your new wealth manager to negotiate an appropriate fee structure, remember that, regardless of the pricing model, the key to all successful business partnerships is that both parties believe that fair value is being exchanged.

### **A Typical Wealth Manager Fee Negotiation**

**1.** The wealth manager has a standard schedule of fees quoted as %-AUM (percentage of assets under management). This schedule typically contains break points. As the assets under advisement increase, the schedule slides down (in percentage terms). A firm might structure its break points as follows:

- First \$10 million: 1.50 percent
- Next \$15 million: 1.00 percent
- Next \$25 million: 0.75 percent
- Thereafter: 0.50 percent

**2.** As the asset size increases past a certain amount, which will vary from advisor to advisor, families are usually successful in negotiating a reduced fee away from the standard schedule (which is an interesting paradox, because the complexity of the relationship and work to be done usually increases correspondingly with the asset size). Families should determine a firm's AUM trigger for renegotiation as part of its overall discussion of the fee schedule.

**3.** After a certain asset size, most families simply won't pay a %-AUM fee—the gross number simply looks too big to be palatable. At this point a negotiated flat fee is often the agreed-upon solution. It is in the best interests of both parties that a flat-fee agreement contains language capturing the specific scope of services to be delivered, as well as a process for periodic review and evaluation of the relationship to ensure both parties remain satisfied.