The economics of the financial advisory industry

Category : Payment of Investment Advisors, Financial Planners, and Investment Counselors

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The Economics of the Financial Advisory IndustryEveryone has similar, yet distinct, financial planning needs regarding their families' financial futures. While more wealthy people (think millions of dollars) have greater complexity to their financial affairs (caused largely by our incredibly convoluted U.S. personal tax codes), everyone needs sophisticated financial lifecycle planning. Whether wealthy or not yet wealthy, families need a personalized way to understand how their current financial behaviors could affect their families in the future. However, few people already own enough assets to justify the high cost of a competent and objective advisor. Only those who are already wealthy now can afford to pay directly for highly personalized, professional financial planning assistance. Direct client payments help to avoid the conflicts-of-interest that are inherent and pervasive in the structure of the financial services industry. The financial services and advisory industry is almost exclusively focused on the interests of those who already have substantial financial assets and not on the mass of Americans who were trying to become more secure financially. Using many hundreds of thousands of what the securities industry calls "producer" employees, the brokerage industry sells investment products and services to clients for transactional fees, asset holding charges, and many other more or less visible investment costs. Governed by the Securities and Exchange Act of 1934, as amended, and state laws, the legal standard of client care by these brokers is the "suitability" of an investment to a client. However, there is huge latitude in what a suitable investment is and how much it costs a client. From the brokerage industry's perspective, the wealthier the client is the better. Greater assets yield more revenue and high profit per hour spent with clients. For example, Morgan Stanley's 2007 compensation plan for their personnel serving retail clients eliminated all compensation for household accounts below $50,000, and it reduced compensation on household accounts under $75,000, unless these client accounts are being charged a percent of assets fee. Clearly, the message to Morgan Stanley sales personnel is to chase wealthier fish. Similar messages are given to broker producer employees in all brokerage firms across the industry.Another large segment of the financial services industry that serves the public consists of about 100,000 independent planning advisors, who are regulated at the federal and/or state levels. Governed by the Investment Advisers Act of 1940, as amended, and by state laws, these advisors have a seemingly more stringent fiduciary standard of client care. However, again there is huge latitude in what constitutes fiduciary care and how much advisory services will cost a client. Most registered investment advisors deliver services that are charged as a percent of client assets under management. However, very often these same advisors also obtain additional revenues from the securities and insurance industry, when they sell commissioned financial products to their clients. Again, the wealthier the advisory client the better it is for the advisory practice. The greater the client assets under management, then the more revenue for the advisory practice and the higher the profit per hour of client service will be.Whether served by a broker or by an independent financial advisor, the economics of the industry are clear. If an individual wants personal professional attention, that individual must already have substantial assets that can generate revenue to compensate the advisor. If clients are to be given personalized attention and the valuable time of the advisor, each client must generate several thousand dollars in fees annually one way or another. The math is simple. For example, if average client servicing requires 20 total hours of attention yearly and a profitable hourly rate is $150 per hour, then the required average revenue per client is $3,000 per year. If $3,000/per year is the client revenue minimum for a practice, then the client needs to have $300,000, if the fee is 1% of assets per year. The lower the assets, then the higher the percentage necessarily must be. Since clients usually balk at much higher fees, the revenue requirements of advisory practices mean that people with less assets will not get personalized services. Clearly, the vast majority of Americans do not fit the industry's economic profile of a profitable advisory client on an hourly basis. This is why there is so much effort to obscure and hide the financial and investment costs that clients actually pay. The more the true cost can be hidden and the services offered as supposedly "free," then the easier it is to profit from the client, but not necessarily serve his or her best interests.See also:Does it matter how financial planners and investment advisors are paid?The securities industry calls marketing and selling: "advising"