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Sameer Kamath, Chief Financial Officer

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Fee-based advisory model: How it works, why adopt it & what it takes to make the transition succeed

Background of the transition story…

Distribution of financial products in most countries is primarily based on the commission model, wherein the intermediary (advisor) receives a commission from the manufacturer (AMC) for the product he sells to his client (investor). Commission rates differed across products, hence there was often a tendency to push products which earned higher commissions leading to instances of misselling. A higher commission product may not always be the correct one for the client's specific goals. Since it didn't always work for the client's best interests, it led to client dissatisfaction and low chances of stickiness. Hence, the fee-based advisory model started gaining ground in financial distribution. This model is believed to work in the best interest of clients in terms of achieving his long-term goals, as it remunerates the advisor for the advice he renders to grow clients' assets. The better the client does, the more the advisor earns. This is expected to enhance the client's satisfaction with the advisor's services and chances of stickiness of assets and repeat business, which should help advisor's income flows and profitability. Due to its inherent benefits for the end-client, regulators globally have been analyzing this model for implementation. UK and Australia have compulsorily banned the commission model for the fee model. A number of advisors in USA, Canada and Continental Europe are making the transition themselves. Following the ban on entry loads on mutual funds in India, many advisors here are also studying if to make a transition. *This note attempts to understand how the fee model works, why make the transition and how advisors can make the transition successful…*

How it works: What is the advice rendered and what are the types of fee structures…

Every client has a goal for the money he allocates, which the advisors strive to achieve by rendering appropriate advice in order to win client satisfaction and stickiness. Planning is the key activity in the fee model, not simply investing

At the upper end, the advice rendered may assess the suitability of asset classes/products given the client's objectives for that money, eliminate unsuitable products and do asset allocation and product selection based on a detailed plan that aims to best achieve those stated objectives. Apart from planning, the advice proposition should track its progress and take timely decisions to rebalance and realign the portfolio as per stated objectives. It may need to budget for liquidity needs that may arise for the client during the period of investment. It may also involve coaching the clients for understanding their lifestage needs, and behavioral coaching to cut off the influence of the noise that publicly available financial news makes on the client. At the lower end, it may simply mean transactional access to a single product for a specific requirement without need for sophisticated planning or advice.

In the commission model, advice was embedded in the product cost. Fee model will unbundle this cost of advice into a separate item which the client will then pay. Fees might be based either on a percent of assets, an hourly fee for the advisor's practice, a fixed annual retainer, a 'turnkey' fee solely for the advice (where client may not execute with him), or profit sharing based on performance. The type of fee structure used might depend on the client relationship, profile etc.

Fee structures can be typically based on:
- **Percent of client assets managed p.a.**
- **Hourly fee for advisory practice**
- **Fixed annual retainer**
- **'Turnkey' fee solely for advice given**
- **Profit sharing based on performance**

Why make this transition…

Changing regulations; Need for advice to build long term savings; Need to improve client satisfaction, Repeat business, Predictable income & profit; Surviving periods of market downturn are some reasons for this transition

- **Need for advice is more acute than ever,** with the responsibility of building retirement savings increasingly on the individuals themselves. Asymmetry in financial literacy between households has also increased the need for advice. Products easily understandable by one is 'greek' to another. Many people also need advice to manage and plan their savings during periods of income stagnancy, as often seen during phases of economic slowdown.
- **Over-supply of free financial info creating noise which is confusing for clients to navigate:** Despite the barrage of publicly available information on a plethora of products, many individuals struggle to chalk out the best plan as per his specific abilities and needs, and need the help of advisors. Investors are often overwhelmed by the overload of free info, and the noise confuses them about which plan is appropriate.
- **Need to rebuild the trust of clients in their advisors:** After-effects of the financial crisis and dissatisfaction at not achieving their goals despite buying products has damaged the trust many clients had in their advisors. Commission model was often misused to sell high-commission products which were not best suited for clients, leading to dissatisfaction, low client stickiness and chances of repeat business. Fee model allows better decisions in line with client's objectives, since his incentive is based on it. This can help rebuild the trust of clients in the advisors.
- **Create predictable income flows:** Misselling often led to dropouts. The constant need to acquire new clients spiked incremental opex and created uncertainties in income estimations. Since fee model addresses goals better, hence improved satisfaction should lead to stickiness of the assets, repeat business and lower incremental opex. This can help advisors gain predictability in income and profits, and aid them in cost planning for expansion. Stable income can also get his business a better valuation, if the advisor wants to sell the practice eventually for his retirement security.

Product pushing in commission model often impacted client stickiness, leading to the constant need to add new clients. Given new client acquisition costs are high, hence sustainable profits is a challenge here. Fee model addresses this to an extent

- **Cushion during periods of downturn:** Commission business looks attractive during healthy transaction volumes, but it can dry up as fast during periods of downturn. At such times, fee based model comparatively helps keep the advisor's head above the water, especially in the % of assets structure. Ability to reduce this income volatility, to some extent, helps maintain business risk better during periods of downturn.
- **Brings in transparency in fees:** Post-financial crisis, clients are increasingly questioning the value their advisors are bringing to the table, especially in context of justifying the costs they charge. Fee model typically makes advisors unbundle the individual fee items as per individual service, which helps bring in transparency to the fee structure and helps advisors justify why they charge what they do.
- **Advisor creates an alpha component which helps build differentiation in a crowded market:** Advisors concentrate on asset allocation, quality products, tenor, rebalancing, prudence etc which can create differentiation and additional clients inflows. It also helps weed out low-quality products as only the good-quality products would be in demand. It is good for AMCs as it removes the responsibility of advice to some extent, so they can concentrate on fund management.

Fee model helps ensure only serious, good-quality advisors are there in the intermediary market. It also helps intermediaries create some amount of differentiation in an otherwise highly competitive intermediary market

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Making the transition successful…

Communicate the transition plan effectively, stressing on benefits for clients & own strengths	Pitch a holistic Service Promise proposition which goes beyond just outperformance	Delivering on the service promise without gaps to achieve client stickiness and repeat transactions	Estimate a reasonable break-even AUM and target those clients which bring in profitability

Communicate the transition plan effectively, stressing on benefits for clients & own strengths

- **Communicate the value proposition of the new model to clients along with its benefit for them, including the strengths of advisor's own advisory service**. Communicate that advisors are working in the best interest of the client in terms of genuinely helping them to achieve their long term objectives by advising on products/plans best suited to grow their assets, not just to sell a product because it earns higher commission. If the client sees value in the advisor, he would continue. If the advisor has faith in the quality of his advice service, he can be more assertive.
- **Meet key clients personally** to explain to them the plan/benefits for transition. Email a letter or concise presentations outlining the plan/benefits, so that they can use it while it thinking over.
- **Take a reco of client feedback/common queries/concerns from the initial interactions** to tweak subsequent interactions accordingly and increase effectiveness. Practice delivery initially with own-company people as role-play to assess if the delivery sounds convincing. Benchmark and map the process done by the successful/senior advisors to train the remaining advisor force.

With whom to start – a dilemma ?
DB surveys in EU show it's the older, experienced, wealthier, financially-educated clients who actually consult advisors more. Hence, might start with that segment first from amongst the client base. Might try one's oldest clients first as there is an established trust factor with them. Advisors can make the delivery sound like they are seeking client's advice/opinion on this transition idea, and not merely informing them. Or else, might try on smaller clients first in order to polish the delivery and gain initial feedback

Pitch and deliver a holistic Service Promise proposition which goes beyond just outperformance

- **Define a compelling and holistic service promise** based on advisor's own capabilities and what clients are typically seeking, and try to deliver on that service promise completely. Service promise needs to be based on client end-objectives, rather than simply outperformance. Assessing market performance of chosen assets is beyond one's control, hence a proposition based solely on outperformance may not show results each year. Instead, **advisors need to broaden the service promise using activities which can be better controlled**, like asset allocation, rebalancing, low-cost investing, planning for lifestage needs, reviewing the progress, tax efficiency and behavioral coaching so that external noise does not influence him. **Stress that the broader scope of services is not really addressed in the commission model**. Also, outperformance is not always perceived positively since it might mean riskier or concentrated portfolios which can swing both ways.
- **Service promise complemented with quality and relevant advice**. Stress to clients that the fee model ensures better quality of advice. Justification for the service is pinned on the claim that it creates long term value for the client, and correct and relevant advice will take clients closer to their goals. This requires methodical understanding of the client's goals for that money, drawing a plan that seeks to achieve this with a service promise, and keeping that service promise. It also involves estimating client's future liquidity needs and conveying product risk factors beforehand.

A test to check if clients really perceive the advice as good quality & relevant is the number of word-of-mouth referrals they can give for new clients. Periodically check client satisfaction via structured feedback. Do not mistake inertia as client satisfaction

- **Lack of proactive communication is a major factor determining client satisfaction**. Delivering on the service promise needs to look at after-sales services too, since absence of this can often lead to client dropouts despite good advice. This includes proactive communication on portfolio updates, reviews, forward action plans, including during phases of down-performance. It helps clients to be aware of where they stand vis. a. vis. their long term goals. Ensure all meetings and communications that were promised in the service promise are met. Use enhanced report formats which are more holistic in their comparison to client goals rather than just concentrating on outperformance.
- **Process-map the service promise to ascertain dependencies for achieving the outcome, develop KPIs based on those and remove any gaps**. Start with the outcome and work backwards to ascertain dependencies. Each dependency is/is part of an activity that helps establish Key Performance areas for achieving the service promise. This can also help address any gaps if they exist. Conduct periodic status-checks during the relationship.

Endevour should be that no gap exists between what was promised to clients and what they actually experienced. Clients' willingness to stick and do repeat business depends on it

Deliver on that service promise entirely, to keep relationships sticky and garner repeat transactions

- **Delivering on the service promise without gaps typically means that the stated goals and client satisfaction are most likely achieved**.
- Successful advisory relationships often generate sizable business through sticky relationships since clients perceive value in the service. Repeat business lowers the incremental cost of client servicing, which is good for profitability, given the comparatively higher cost of client acquisition.
- Explore aligning the advisor's incentive structure with client satisfaction levels & repeat business volumes. Also, sticky relationships might be convinced to pay more for additional new services.

Transparency in costs is also a part of the service promise. Itemize all the activities involved in delivering that promise. Price each stage separately if possible to bring in transparency in fee. Nobody likes last-minute surprises

Estimate a reasonable break-even AUM and target only those clients which can bring in profitability

- Advisors cannot expect to retain every client post-transition, and may also need to resist from adding every prospect due to viability reasons. Advisor's success depends on focusing on clients who can help build long-term profits. Advisors can **estimate the minimum client AUM level required at which he can profitably render his service.** Using his opex/other costs, assume the break-even revenue level. Using the percent of AUM method and a typical fee of 1-1.5%, divide the break-even revenue by the fee to get the break-even AUM needed to ensure that the cost of servicing is at least met. Depending on the number of clients in the system, it should give a reasonable level of break-even AUM.
- If this break-even AUM is higher than realistic market standards, the advisor needs to relook at his costs to be able to do the business at a lower minimum AUM. Advisors might also identify a range of AUM levels for different segments of target clients based on different costs of servicing.
- For clients below this break-even AUM, retain them if possible by lowering costs using standard template advice-matrix, using call centers or using junior advisors. Or at least help them transition to another advisor, because this is a business where relationships are all that matters.

Do not expect to retain every client or try to acquire every new prospect, because the larger need is to build the correct client base which is ultimately capable of giving profitability to the advisor's business

Advisors might look to develop these metrics while deciding whether the transition is the correct choice, and to make the transition easier:

Prepare comparison sheet of pay-outs of key clients as per the commission model, and what these would have been under the fee model. While transactions would have different in either model naturally, nevertheless, it might give a rough idea of which option would have been beneficial

Prepare an index of client satisfaction based on variables like extent of flows from repeat business, client churn rate, new client referrals from existing clients, feedback scores received, etc. Use this to estimate how the advisor ranks in terms of existing client satisfaction and if an improvement is required at all

Prepare separate fee matrix as per different asset sizes, along with fee per individual service, and assess if the final pay-out for the client is within acceptable limits. Might also explore the option to maintain part of advisor incentive structure based on actual asset growth achieved

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Challenges that may arise…

- **Transition may result in losing some assets/revenues initially** since there would be some clients who prefer the commission model for its transactional nature. However, surveys in developed markets show revenues recover soon after this dip and, in fact, sustain its growth in case of the quality advisors. Nevertheless, **advisors need to be financially capable to handle the initial hit**
- **Convincing clients to pay since they are used to getting advice 'for free'**. Advice cost was embedded in the product cost in the commission model. Moreover, internet and TV have made information easily available, almost for free. **Advisors need to justify their fees by showing the value they are bringing for the client. Simply giving product comparisons may not find takers**
- **Getting over the mind-set challenge**, given a portion of the advisors who are ageing and are now deep-set in the established way of doing this business are themselves reluctant to change
- Advisors need to assess their current capabilities/skills and ascertain whether there are any gaps in their abilities to deliver the requirements of the fee model. **In case of gaps, they should have adequate financial resources to bring in additional resources.** Incremental cost of resources has to be suitably monitored to ensure the incremental business it brings in justifies its cost
- **Cost of investment might increase in some cases, especially of buy and hold**, since it really depends on the actual rates and any reduction in trail over time. Also, **need to ensure low-cost products are combined into the portfolio** to minimize portfolio costs, since the fee model may not always reduce asset turnover since every asset strategy may not be a buy and hold strategy
- **Ensuring incremental portfolio cost due to transition is minimal** using no-load/low-load funds
- **Measuring quality of advice** using periodic reporting, checklist of service processes, structured feedback and achievement of long-term goals
- Fee model creates a natural incentive to advice richer, larger-account clients due to economies of scale. Hence, the needs of clients with smaller accounts might get ignored in the fee model
- Linking incentives to advice and client satisfaction may not always increase advisors' quality

Advisors need to ask a few questions to themselves before deciding whether to make a transition or not:

- ***Do they have confidence in the quality and relevance of their own advice?***
- ***Do they actually have capabilities required for the fee model, and if needed, can they acquire capabilities?***
- ***Why are they in the business - To build and sustain it for the long-term?***
- ***Is this their main source of income or a supplementary source of income?***
- ***Is the volatility in income and profits giving them sleepless nights?***
- ***Given their client profile and typical investing behavior, will the new model improve client satisfaction, retention & repeat business from current levels?***
- ***Given their client profile, are clients seeking to achieve long term goals, or just looking for one-off transactions?***
- ***Are they periodically spending a large part of their time in acquiring new clients to replenish drop-outs?***
- ***Is it possible to ascertain that drop-outs occurred because clients were not happy with the product sold to them?***
- ***Would a majority of their existing clients give word-of-mouth referral?***

Co-existence of market-structure variants expected, going forward…

In some countries, regulations banning commissions led to total adoption of the fee model. If regulations do not necessitate it and given that transition itself will be a gradual process, then variants of the market-structure might co-exist, apart from the full fee based model.

- **Hybrid for old/new clients:** If advisors feel most existing clients would be disinclined to shift, instead target only new clients with fee model
- **Hybrid for the same client**. Where fee is for a specific advice only, and a separate commission for execution service if it is done through him
- Commission model might be relevant for **low-value clients and new clients in smaller towns** where fee model might see less acceptability

Conclusion…

Following this discussion on why is the transition happening and how advisors can make it successful, it is difficult to say which method would be more advantageous. Advisors really need to assess their client's profile, investing behavior, longetivity and satisfaction, as well as their own capabilities and strengths to ascertain whether making the transition will be the right move. The transition will be a slow and gradual process. Clients will want to know what's in it for them. Advisors will have to convince them of its benefits and stress that it makes advisors work in their best interests. Advisors need to understand the actual objectives of their client for that money and implement a strategy to achieve it by deciding on allocation, tenors, rebalancing, cost of investing, review etc. Desire to achieve long-term investment results is a precursor to the desire to adopt the fee model. However, the fee model may not always be beneficial from the client's perspective, since advisors may not advice on actions like reducing debt etc, which does not really gain them. **At the end, profitable growth makes a valuable and sustainable business. Hence, sustaining profitability should be the objective that advisors need to think of ultimately.**

Clients place trust based on advisor's success. Hence, it might be better to underpromise and overachieve, rather than overpromise and then fall short

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