How Do Financial Advisors Get Paid?

For over a decade, I worked as a stockbroker (my card said financial advisor) at two of the largest Wall Street brokerage firms. During my time with these sales institutions, I don't think I could count the number of times that clients and prospective clients asked me, "How do financial advisors get paid?" Back then, I would go to lengths to explain the 21 page Financial Advisor Compensation Plan. The end result? I think my clients greatly appreciated my attempt to provide transparency while working in an extremely nontransparent business. My clients trusted me and that was what was most important. However, I also felt that they never fully understood just how stockbrokers get paid and were always skeptical of the firm. This article will attempt to shed some light on a very confusing subject and provide a look at some of the hidden fees stockbrokers and their firms earn.

The Grid

This is a term used to describe a chart that includes breakpoints for stockbroker production levels. The example below is applicable to stockbrokers who are employees of large traditional Wall Street brokerage firms. Grid payouts for independent stockbrokers are significantly higher. Production is a term for fees & commissions. Hitting breakpoints on the grid allows one to receive a greater percentage of her production. For example, a grid may look like this:

Trailing 12-month production (fees & commissions)

From	To	Grid Payout Percentage	Wrap/Insurance/Annuity Percentage
$3m	+	44%	47%
$1.75m	$2.99m	43%	46%
$1m	$1.749m	42%	45%
$750,000	$999,999	41%	44%
$600,000	$749,000	40%	43%
$400,000	$599,000	38%	41%
$300,000	$399,000	34%	37%
$250,000	$299,000	32%	35%
$200,000	$249,999	29%	32%
$0	$199,000	27	30%

To simplify an example, suppose a stockbroker produced $1,000,000 of production for 2012. Her W2 Income would look like:

2012 production	$1,000,000
Grid payout	X 42%
Pre-tax W2 income for the stockbroker	$420,000

But what if the stockbroker instead only sold the higher paying products like insurance, annuities, et al? Then her income would increase by $30,000 per year! Instead of getting paid 42%, she would be getting paid 45%. This compensation scheme creates a serious conflict of interest. Some firms pay their stockbrokers a higher percentage payout on certain products vs. others. This compensation strategy will incentivize the stockbrokers to push some products over others, whether the products are the best for the client or not.

The other glaringly obvious problem with this compensation scheme is that by instituting breakpoints with higher payouts, there is an obvious pressure on stockbrokers to produce more so that they can get a higher payout. Now let me be the first to say that incentivizing your sales employees to sell more is a great idea and many successful companies have been built in this very fashion. However you don't want the advice you receive from your advisor to be overly conflicted by how he gets paid. What if your financial advisor is very close to the next breakpoint on the grid? What if he sells you a product that while suitable for you his true motivation is to simply to generate enough commission to cross over into the next highest payout bracket? The grid presents conflicts of interest that are very difficult if not impossible for the average consumer to properly evaluate.

Annuities; big commissions and high fees

I have met with hundreds of investors over the years who owned annuities and NOT ONE was able to explain to me how much in commission the agent who sold them the policy was paid. Nearly every time I explained to an investor the actual amount of commission they paid for the annuity they owned, they would be extremely surprised. You see, when you buy an annuity, the commission amount is buried in that huge prospectus the agent gives you. If you are very good at reading complicated documents, you will find the percentage commission. But what you won't receive is a statement showing the absolute dollar amount of commission from your policy that was paid to the agent.

To illustrate a typical annuity commission, let's begin with what the broker generally receives. 7% is a common commission amount for variable annuities. The commissions on some products can even be as high as a whopping 10%. For this article's sake, we will assume that we are looking at annuities from large, reputable insurance companies and in that world the standard commission is around 7%.

Variable Annuity purchase amount	$500,000
7% commission factor	X 7%
Stockbroker's commission	$35,000

Most annuities also pay a trailer commission. With many of today's annuities the trailer commission is around 1%. That means that the agent will get paid a residual payment every year that you own the annuity.

Some financial advisors are highly skilled at flipping their clients from one annuity to the next about every 4 – 7 years, depending on when the back-end charges wear off. The good news here is that regulators scrutinize these 1035 exchanges to protect investors from being churned. The bad news is is that the insurance industry is constantly coming up with new features for their products so financial advisors can use the latest feature on the then current hot annuity and conveniently get around regulatory hurdles.

As a final note on annuities, let me say that annuities themselves are not all bad and some can be highly beneficial to a client in certain circumstances. The problem lies in how financial advisors are paid to sell them.

Life Insurance; 100 percent commission is the norm

So if you were surprised by the annuity commissions, how about life insurance? Would you be shocked to know that many life insurance policies pay 100% in commission for the first year's premium? That's right; whatever you wrote a check for in the first year of the policy, a good rule of thumb is that 100% of that amount was commission. The agent may or may not receive all of that commission depending on where she is employed. For an employee of a brokerage firm, the firm is paid the entire commission by the underwriting insurance company and then gives the stockbroker her cut of the goods. Some agents, those who are independent, will get the entire commission.

Talk about conflict of interest! The next time that your financial advisor is trying to talk to you about an estate planning strategy, pay close attention!

Life insurance can be an extremely valuable component of your wealth transfer strategy. What the average investor doesn't know is what type of policy (VUL, UL, Whole Life, Term, etc.) is most appropriate. Other important decisions are how to own the insurance (individually vs. a trust) and who the beneficiaries should be.

The best advice here is to have a trusted estate planning attorney, CPA, or fee-only investment advisor involved in your insurance planning. It pays to have another set of eyes watching over this type of transaction, especially if those eyes are not getting any of the commission involved.

Structured Notes

Structured notes are a product manufactured by Wall Street Investment banks and sold with an embedded commission in it; similar to a used car. Years ago bonds would carry as much as 5% embedded commission. Over time competition from discounters and the availability of market data has pushed bond commissions down significantly. In a search for revenue and new ideas for clients, investment banks invented structured products. Many new issue structured notes have 3 – 4% commissions embedded in them. Buyer beware! When your stockbroker trys to show you a leveraged play on the stock market with principal protection keep in mind that there could be a significant commission behind that trade. Because her investment bank may have manufactured the product (structured note), the commission will likely be built into the price and may not be that obvious to you.

IPOs and New Issue Closed End Mutual Funds

Similar to structured notes, IPOs and closed end mutual funds (new issue) carry an embedded commission. Close End Fund commissions for new issues tend to be about the same as structured notes, up to 4%. Equity IPOs tend to smaller, typically 1% or less. In either case, the commissions may not be so obvious because they are embedded in the underwriting process. Be very careful when dealing with stockbrokers who specialize in new issues. Chances are that they have perfected a churning operation that while legal, is certainly not in your best interest.

Limited Partnerships can have significant non-transparent loads

Limited partnerships can give you access to private equity, real estate, hedge funds etc., all of which can be valuable in your portfolio. What you have to watch out for is a commission driven sale. Many of the limited partnerships sold though stockbrokers carry exceptionally high fees. Do your homework before you buy! Another way to look at these limited partnerships is that you are paying the stockbroker, her sales manager, her firm's shareholders, the firm's dedicated limited partnership consultant (who teaches the stockbrokers how to sell the investment), and last but not least the managers running the money. Wow, that is a lot of people to take care of!

You can expect that the stockbroker will receive a 1 – 5% commission (and sometimes up to 10%) to put you into the partnership and then a 1 – 2% annual trailer commission.

Margin Interest & Credit Lines.

Many firms will pay their financial advisors a cut of the margin interest and loan interest from credit lines, mortgages, etc. Brokerage firms like to change the payouts on these products frequently so it is anyone's guess as to what exactly your financial advisor is truly getting paid – just know that she is getting paid and that alone should raise some flags on whether the advice to take out the loan was a good idea or not. In fact, it is important to note that credit lines in particular are exceptionally profitable to brokerage firms. So much so that many brokerage firms have campaigns (letters, call nights, etc.) to notify their customers of the availability of credit lines.

How do you avoid product sales and get a fair deal?

Fee-only registered investment advisors (RIAs) don't sell products, don't accept commissions and operate as fiduciaries. The key is to find someone who promotes themselves as fee-only. In order to hold yourself out as a fee-only advisor, you cannot also sell life insurance, annuities or any other investment for commission. Note that a large number of advisors are fee-based and not fee-only. Fee-based is not the same thing as fee-only. ***Knowing the difference between fee-only & fee-based is very, very important.*** A fee-based advisor can also sell you investment products for commission, life insurance etc. Thus, if you want to get away from the headaches and uncertainties associated with most financial services providers, find a fee-only registered investment advisor. By working with a fee-only RIA you will have the benefit of knowing that you are working with someone who is legally obligated to put your best interests ahead of hers. Additionally, you will be able to sleep at night knowing that the only compensation that your advisor is receiving is the fee that you are paying her - transparent, easily understandable, and fair.

To find a fee-only RIA a good place to start would be your attorney or you're CPA or possibly a friend or family member. You may also want to conduct an internet search of fee-only RIAs in your area. Interview several and then make your decision.

About the author of this article.

Ethan S. Braid, CFA is the founder of HighPass Asset Management – an independent, fee-only, registered investment advisory firm with a fiduciary duty to the clients it serves. Mr. Braid has been passionate about managing client investment portfolios and providing customized financial planning advice since he started working in the investment industry over 20 years ago. Mr. Braid earned a BS in Finance from Robert Morris University, an MBA from Cleveland State University and he is also a CFA Charterholder.

Mr. Braid is devoted to being an expert in the field of wealth management for high net worth individuals and families and for many years, has read one book per month on subject areas such as: estate planning, retirement planning, investment analysis, mergers & acquisitions and behavioural finance. Mr. Braid also has a passion for business history with a focus on the late 19^{th} & early 20^{th} centuries. To date Mr. Braid has read over 100 books on the subjects listed above.

When Mr. Braid is not helping clients, he enjoys: cooking, wine, exercise, his yellow Labrador retriever, fly fishing, hiking, travel, playing guitar, duck hunting and riding his horses.