

TOOLBOX

By John De Goey

DE-COMMISSION MISSION

Educating clients is the first step in switching to a fee-based practice.

With power plants, the term “de-commissioning” refers to closing them down. But I use the phrase to refer to advisors who are considering shuttering an old-school, commission-based advisory practice in favour of a fee-based practice.

As an advisor who works primarily in the mass affluent market, families with \$200,000 to \$600,000 in investable assets, there are a number of things I did to facilitate my own transition. Step one was to start communicating the idea of a fee-based practice to my clients. Shortly after deciding on the change, I began mentioning it consistently in my formal correspondence, newsletters, e-mails, phone conversations, and most importantly, in face-to-face meetings. It didn't matter which avenues I used to communicate my plans, so long as my rationale about the benefits were conveyed clearly and repeatedly.

What I told my clients was that not all investment products pay the same rate of compensation. I explained stock mutual funds pay advisors more than bond mutual funds and that I sometimes make more money if I recommend a certain product within their portfolios. I further explained I'd make every effort to only use products that pay me no commissions and no trailers, so the only way I get paid is when a client writes me a cheque. In the case of something like a venture capital labour fund that does pay a trailer, I'd disclose the commission to them and reduce my fee, dollar for dollar.

Once they grasped the basics, I went deeper and explained there are products I believe to be better and



cheaper, but that I can't use them if we remain in a commission-based relationship. Those products allow me to make more money, because I have to pay less to the distributors. My fee is 1.5% on the first quarter million, including GST, and 0.75% on anything between \$250,000 and \$2 million, and then 0.375% on anything over \$2 million. It's a marginal fee rate. But the best news is that the amount clients will have to pay me for service, and pay for the products, is still less than under a commission-based model. Say I save 1% of product costs on a \$400,000 account. That's \$4,000 total. I then could do a 75/25 split and pass \$3,000 of the savings to the client and keep \$1,000 for myself.

Next, since I had been using deferred sales charge mutual funds, I wanted to make the transition as painless as possible for clients. I told them I would begin moving

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to a fee-based model in July of 1999 and did 10% free redemptions that year and the year after. For clients with non-registered accounts, I stressed there may be capital gains or capital losses involved, and I tried to quantify them if they were significant.

In actual fact, the transition did not begin until 18 months later, in January, 2001. By then, about 27% (10% in 1999, 9% in 2000 and 8% in 2001) of all previous DSC assets had been moved to non-DSC assets. Furthermore, all new assets invested over the previous 18 months had no associated loads and all remaining DSC assets had reduced their redemption schedules. Some of the funds invested in 1994 or earlier were free of back end load charges, because those charges had run their course.

Next came the biggest step. I wanted to disclose my compensation and the total cost to the client (both what it costs to get out of the old paradigm and the total ongoing costs under the new). And I wanted to do this in writing, with the client's sign-off. The announcement of dates for which clients would break even, in terms of cost to them, produced a few surprising reactions. Some who would have been better off almost immediately resisted the change. Others who would take eight years to break even opted to switch without flinching.

Practically speaking, the only way to reach a point where the client is financially better off is to use cheaper products. Again, I was at a crossroads—this time over which suppliers would get access to my

practice. Advisors working with individual securities would likely have it easier than I did. Using mutual funds is a little tougher because fund MERs representing the total client cost and advisor compensation are embedded in that cost.

The products I now use cost considerably less than those used by many other advisors, and the fees I charge are typically a little more. Still, the sum of the two is almost always lower than under the old status quo.

The concept of short-term pain for long-term gain is far more saleable if experienced by both parties. In many instances, I waived my first-year fee for clients who would need to absorb DSC charges. When clients complained of the cost, I could look them in the eye and say, "I feel your pain." If you're seriously considering making this change, set up a line of credit while your income is still strong. You'll need it to get through the early transition years.

The change also opened up a universe of excellent products from which I built unbundled client portfolios. These include asset-class funds and exchange-traded funds. Generally, I tend to use only these unless my clients request something else. For example, I had a client who wanted to use a particular small-cap fund, because he had business ties with an executive at the company. That fund would rank lower on a list of those I'd choose from. It's an active fund, but at least it's cheaper than some. In another case, I had a client who had business affiliations with two other fund companies. He asked to use their funds, and I did, even though I wouldn't normally recommend them. What's

important, though, is to document instances where clients are making these requests. I will ask clients to sign a document when a purchase runs contrary to my advice. It's always best to have a paper trail if there's any doubt in terms of liability.

If you're an advisor who has used wrap accounts in the past, consider this: There's no reason why you can't offer most of the benefits associated with a wrap account yourself. Written investment policy statements and portfolio re-balancing are two things any advisor should be able to do without help from a product supplier.

I do portfolio re-balancing by hand. People adding money to their portfolios should continue to buy low and sell high. People who are retired need to sell high, so they unload investments that are worth disproportionately more now than when they were purchased—you've got three or four investments in your RRIF, so sell the one that's gone up the most.

My income dropped for the first three years of the transition. I then spent the next three making more than if everyone had stayed the course, but I was simply making up ground I had initially lost. It's only now—six years later—that I am making a good living again. The initial drop is significant, but the long-term rewards are substantial. Like the old saying goes, "If you want to get to heaven, you have to die first." **AE**

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