Fee Based VS. Commissions  

On the surface, commissions appear to be less costly to an investor. However, closer examination reveals a different story. Let’s assume you invest $100,000 in a mutual fund with a 5.75% front-end commission. You will immediately have $5,750 deducted from your account on the first day. If instead, you paid 1% of the value of the account each year for seven years then you would end up paying $7,000 in fees—not counting the fees from the account increasing in value. As the value of the account goes up, so does the amount paid in management fees. On the other hand, the up-front commission was only based on the initial investment. Why would I say that it is more expensive to pay a commission?

First, this simple example above does not take into account the true costs associated with investing over that seven-year period. Things like expense ratios which are charged by the Mutual Funds and ETF’s in addition to the upfront commissions. If you maintained the same investment for seven years and didn’t make any changes along the way, you would indeed benefit from paying a commission versus fees. But wait, there’s more to the story.

Studies have shown that the average length of mutual fund ownership is less than 2 years! Therefore, it is highly unlikely that you will hold the same funds for seven years. Actually, investors are likely to go back to the broker that received the initial commission (or to a different one) to complain about the performance of the investment. This leads to new recommendations; and another commission.

In addition to mutual funds, variable annuities and equity indexed annuities have high costs but they are even more obscure. If you need to withdraw your money because your situation changes or you’re unhappy with the annuity’s performance, you will be subject to a hefty surrender penalty. This is often couched as a CDSC or Contingent Deferred Sales Charge. The broker pitches it like this: “there are no upfront fees so all of your money goes to work immediately. As long as you don’t surrender the contract early, you don’t pay any fees.” The amount of that penalty should be considered part of its cost.

Service after the sale may suffers when you pay a commission versus an ongoing fee. Commission-based advisors can justify earning their commission by saying that the client is paying for 7-10 years worth of service up-front. How can the client quantify an advisors service over that many years? What if the advisor is no longer available? Nonetheless, the broker gets the commission regardless of how much service they provide or how poorly the account may perform. You can easily discern by now, the commission-based advisor doesn’t risk his/her standard of living; regardless of their performance. Furthermore, being paid by commissions could be an inducement to make unnecessary trades. The fee-based advisor doesn’t face this dilemma since their compensation is based on asset size and performance rather than transactions.
Paying a management fee gives the investor CONTROL over the relationship. You can change investments or move your account, at any time, without additional costs. As a fee-based advisor, the only way I can improve my standard of living is to first improve yours. Most investors are agreeing that they would rather have the advisors compensations tied to performance; this engenders a client/advisor alignment without biases to product or transactions.

Don’t be duped by the argument that it costs less to pay a commission than work with a fee-based advisor. A fee-based advisor might seem more expensive because you see the costs as they are billed. But don’t be tricked into believing that a commissioned based account is free. After all, if they are really a better deal, why not make full disclosure of how they charge in bold print rather than hard to read jargon found in prospectuses.

Fee Based vs. Commission Based Financial Advisers: A Final Word

Ultimately, an investor who is relatively sophisticated and can manage their own investments would probably be better off using a discount brokerage or making their own trades online rather than using a fee or commission based advisor working for a full service brokerage. However, if you are not comfortable investing on your own, then a fee based financial advisor rather than one motivated by transaction volume will most likely be the best option.