The Compensation Structure of Financial Advisors and the Impact on Client Trust and Credibility

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Background

There has been considerable discussion regarding the various methods clients use to compensate financial advisors and if the methods used, either fee based, product commission, or a combination of both, materially impacts the client's financial behavior and their perception of their advisor's objectivity. There has also been considerable review of how a conflict of interest perception is a material and "moral hazard" factor determining where the commissioned based financial advisor ultimately fits into the client's decision making process. The purpose of this case study is to further evaluate these issues and add to the current level of research.

Conflict of interest perceptions also represent performance issues for advisors because if advisors tend to perform to the situation and they do not feel trusted, they may not act as trustworthy. Fee-based compensation better aligns adviser and client interests and according to John Robinson (2006) "some advisers have adopted an almost moralistic position in advocating the exclusive use of fee-based models"**.**

Theory

This study's hypothesis is premised on the basic theory that the payment method used to compensate a financial advisor has considerable influence on how clients perceive their advisor. Previous studies and research have shown that advisors earning their compensation through transaction based commissions will rarely sit on the "same side of the table" as the decision makers (Maister et al. 2000) or have the influence of the fee based only advisor. According to Sung Bae and James Sandager (1997), while some individuals prefer to compensate their personal financial planner on a combination hourly/flat fee and commission basis, a *majority* prefer to pay their advisors exclusively on fee-only basis.

Research and personal experience over the last 40 years working in the corporate environment years has proven, with little doubt, that individuals working on commissions, or even a combination of fees and commissions, are treated as self-interested and conflicted salespeople and must continually answer the client question: What's in this for you? Clients trust people that are *not* impacted monetarily by what they buy. Corporate clients are intelligent and prudent people who also believe that without any influence to the contrary, such as being paid on the basis of what is purchased, it is only human nature that advisors will have no motivation other than to work solely in the client's best interest.

Research Questions

This study poses two research questions: Do fee only compensation arrangements materially enhance a client's trust in their advisor and raise the advisor authority levels? Do commission or transaction based compensation arrangements really impact advisor credibility?

Survey Design

This case study is premised on two survey design methodologies. On element of the study was facilitated using my position and experiences as Principal of the Capstone Actuarial Group and President of The Healthcare Research Foundation. The longitudinal type survey spanned the period of 1994 through 2014 and involved 20 corporate healthcare clients that employed between 500 and 5,000 employees. The firms participating in the trial had to establish and be governed by formal insurance committees that were chaired by someone in a position no lower than the Chief Financial Officer.

These firms were asked to hire an advisor (Capstone) under a proposition where the advisory firm would not engage under any financial compensation arrangement *other than* hourly based fees. It would be a prerequisite that the advisor be instrumental during all material healthcare plan funding and risk discussions and ultimately have the authority to make the *final* decision.

The second survey design methodology was based on a study authored by Sung Bae and James Sandager (1997) using a survey of 227 individuals who were asked 10 questions about their attitudes regarding financial planning professionals. Questions involved a number of issues about their expectations, but the most relevant issues as it pertained to this study were about compensation methods and their particular fee methodology preference.

Results/Critique

The study by The Healthcare Research Foundation (THRF) and the Capstone Group showed that high level financial decision makers clearly and overwhelmingly want to compensate their financial advisers on a fee only basis. 100% of the *firms* that participated in this survey either were already using a fee based arrangement or subsequently adopted that fee method. The results showed that the decision makers were much more likely to take direction directly from their fee based advisor and involve them much more in the decision making process. After a trial period of at least three years, 100% of the participants also concurred that the logic of the fee based relationship had in fact created a greater atmosphere of trust between their firm and the advisor.

The survey by Sung Bae and James Sandager (1997) showed that 80% of *individuals* prefer to compensate their personal financial planner on a combination hourly/flat fee and commission basis, with 55% preferring to pay advisors *exclusively* on a fee basis. Only 20% of the individuals surveyed said they were satisfied or comfortable with compensating their financial advisor on a commission only basis.

Conclusion

The research questions developed for this study were clearly defined and thoroughly answered by the survey results. The survey and experience involving the 20 employer *firms* confirmed that seasoned corporate decision makers understand and appreciate that working with fee based, well credentialed advisors, who are free of any transactional conflict, will create an environment conducive to trust and enhanced authority. They relate to the fact that while paying fees doesn't eliminate all possible moral hazards, fee practitioners appreciate the level of trust with which they are endowed and will usually perform accordingly. The surveyed employers universally accepted the premise that individuals being compensated by commissions tend to be subjective and conflicted and are to be kept at arm's length.

The survey by Sung Bae and James Sandager (1997) showed that from a more personal perspective, individuals understand the issues of subjectivity as it relates to commissioned salespeople and they much prefer to pay for advice, separate from product commissions.

While building on the research to date on this subject is certainly anticipated and appropriate, it does appear that both corporate and individual buyers of advice do in fact clearly separate advisors that are fee compensated directly by them, from individuals who "take a cut" from what they pay for products via vendors.

References

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