



CFA Institute

# FOCUS ON FEES



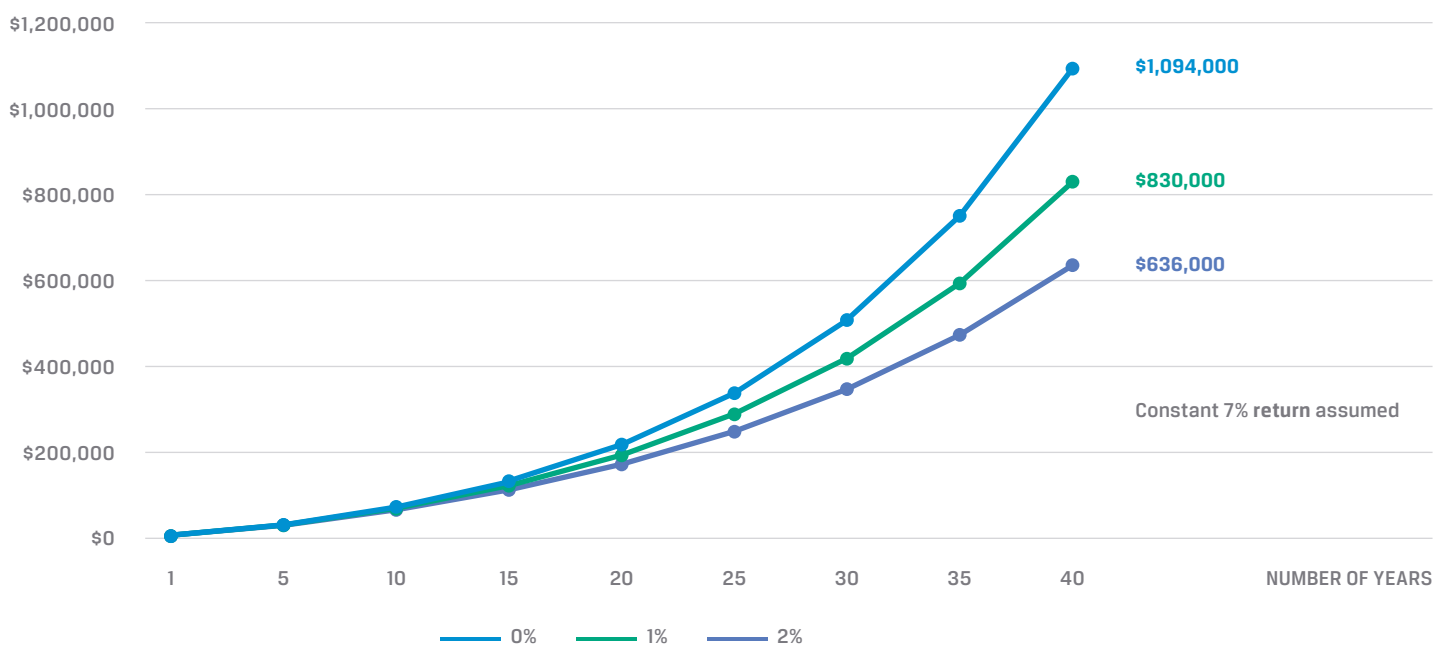
The CFA Institute [Statement of Investor Rights](#) lists the rights and expectations investors are entitled to expect when working with financial professionals. Among these is a right to **"an explanation of all fees and costs charged to me, and information showing these expenses to be fair and reasonable."**

Taking an active role in your financial future means making some important decisions, either on your own or with an adviser. These decisions include: how much to invest, the type of assets to invest in (asset allocation), the investment products or securities to purchase (security selection), the amount of decision-making responsibility (discretion) that you will maintain or give to your service provider, and how much you are willing to pay in fees.

**Investors often don't realize—or ask—what fees they're paying for products or services. Fees add up over time, and investors should be sure these fees reflect the value they are getting.**

Over a long period of time, a small decrease in fees translate to a large increase in capital. For example, the chart below shows the value of a portfolio given a \$5,000 per year investment for 40 years, assuming a 7% return. Each 1% reduction in the fee rate would increase this portfolio's value by 25–30% (about \$200,000).

## EFFECT OF FEES ON TERMINAL WEALTH



### Keep in mind that there are two main types of fees:

- 1. Product or fund-level fees:** These are embedded costs but can vary significantly. Types of fees include up-front sales fees (called load fees), marketing fees, custodial fees, redemption fees, transaction fees, and fund-level investment management fees.
- 2. Fees for investment services:** These fees will be determined by the services required. Brokers may charge account fees and fees for executing transactions, while advisers may charge additionally for planning, managing investments, and, if required, making investment decisions.

A financial adviser can add significant value by keeping you on track toward your goals and helping you navigate through volatile markets.

Your adviser can also help you understand and avoid some of the product and fund-level fees.

Pursuing the lowest fees possible may not necessarily be the best strategy in the long run—the important thing is to understand the value of the fees you are paying.

Fees should be structured to support the services provided and should be viewed as tools that align the interests of investment service providers and their clients.

This guide explains the most common fee structures when working with an investment professional.

## Fee Structure

## Pros

## Cons

### Transaction-Based Fees

In these arrangements, investors pay for transactions made on their behalf. For example, retail brokers charge transaction fees for buying and selling securities. The commission rate and fee calculation vary based on the product, such as equities or commodities.

- Many are explicit commissions: clients see how much they're paying for each service.
- Clients often retain investment discretion and can say "no" to recommendations.
- Investors who do not require investment advice can hire professionals for an "execution-only" account.
- The model provides services at low cost for buy-and-hold investors who don't purchase or sell securities often.

- Conflicts may result, because service providers have incentives to:
  - sell more products to generate higher commissions;
  - move clients into and out of investment products (churning);
  - sell higher-commission products; and/or
  - recommend transactions regardless of suitability.\*
- Service providers are often not required to put client interests ahead of their own.\*
- Tiered commission-based fees may not be clear to investors.
- Fees are based on transactions and not investment performance.

### AUM-Based Fees

In recent years, investment firms have stopped offering traditional commission-based services in favor of flat fees or fees based on the value of investors' assets under management (AUM).

Depending on the services, service providers may lower the percentage charged as the client's assets grow.

- AUM-based fees are easy to understand, relatively transparent, and predictable.
- Service providers have less incentive to recommend expensive third-party products.

- AUM-based fees may weaken incentives for service providers to seek higher performance.
- Potential conflicts of interest may arise:
  - Service providers have an incentive to grow the asset base, so they might encourage clients to consolidate assets with them when better alternatives are available.
  - Service providers might be biased toward larger clients or accounts.
- Larger accounts don't necessarily require extra effort so may not justify higher fees.

### Performance-Based Fees

Wealthy individuals and organizations such as banks and pension funds are permitted to invest in higher-risk asset classes (e.g., hedge funds) that use performance-based fee arrangements. Because of the risk, complexity, and return potential, these products typically require hiring professionals with specific expertise.

- Performance-based fees can mean better alignment of service provider and client interests.
  - Fee structures often include complex provisions such as hurdle rates (minimum return level before fees are earned) or clawbacks (ability to recoup fees paid if returns fall below hurdle rates).
- Service providers earn only when investors achieve predetermined minimal acceptable returns.

- Fees are unknown at the outset and can be high.
  - Hedge funds can have high performance fees for returns that exceed hurdle rates or high-water marks.
  - Buyout funds can have carried interest plus deal fees.
- Asymmetric fee structures limiting downside risks may encourage service providers to increase risk.
- Good early performance could encourage service providers to reduce risk to lock in prior gains.

### Flat and Project-Based Fees

In flat-fee or project-based arrangements, providers unbundle their services and charge flat fees for each. Some fees recur monthly or annually. Others are billed hourly for time spent managing the account. Still others are one-time charges for specific projects. Investors can choose specific services and investment approaches that best fit their needs.

- Advice is not determined by the need to trade or buy specific products.
- Fees are transparent.
- Clients control how much is spent and on what services.

- Service providers may recommend additional work when it's not appropriate.
- Service providers have an incentive to seek new clients to increase revenue, potentially lowering service quality.

### Consider the following questions when evaluating fees related to professional investment advice:

- Do you understand the fee structures, how they impact your portfolio, and how they align with your interests?
- Are the fees charged appropriate for the service level you are getting, or expect to get in the future?
- Are your service providers compensated in return for selling you products or services?
- Could higher fees or a different structure lead to better performance?
- Is the fee structure fair compared with other available arrangements?
- How does the service provider mitigate potential conflicts of interest (especially pertinent with commission-based fees)?
- Is your service provider legally bound by a suitability or fiduciary standard?\*

#### \*Fiduciary vs. Suitability Standards

The term "fiduciary" generally refers to the requirement for loyalty, prudence, and care for those who manage assets for the benefit of another person. Fiduciaries have a duty to put their investors' interests before their own and disclose potential conflicts of interest. In some markets it refers to a person legally appointed and authorized to hold assets in trust for another person. Those who work under a "suitability" standard only need to ensure that their recommendations are consistent with investors' needs, objectives, and circumstances given their income and age.

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