Flat Fees or Fat Fees?
Did Your Client Get a Wrap Account or a Bum Wrap?
By Douglas J. Schulz, CRCP, RIA

Flat fee or wrap fee accounts are all the rage these days. Each brokerage firm has its own special title for these kinds of accounts, but they all have one similarity - the investor is charged a flat percentage per year on the total assets in the account. Flat fee or wrap fee accounts are not totally new. In one format or another they have been around for several decades.

One of the main questions that need be asked is why these types of accounts have become so popular in just the last few years. The answer is that it's not necessarily the investing public that has demanded these accounts but rather they have been pushed by the brokerage industry and by the stockbrokers themselves. Article after article in publications such as Registered Representative magazine has alluded to the increasing pressure by brokerage houses on their stockbrokers to convert more of their accounts to flat fees. One way that firms lure brokers to the flat fee account is to pay them a higher payout on flat fee accounts. Firms conversely penalize the commission broker by paying a lower payout on the traditional account.

There are industry professionals that feel that within the next 10 years, some of the major brokerage firms will have totally phased out commission stockbrokers. At that point stockbrokers at larger firms will either be salaried individuals, or like institutional portfolio managers, the brokers will receive a percentage of the fee being charged by the brokerage firms. It is easy to understand why big brokerage firms would like to go in this direction. Even though the major brokerage wire houses have some of the lowest commission payout percentages in the industry, they still pay out to brokers somewhere between 30 to 50% of gross commissions. This payout structure has always made stockbrokers one of the highest-paid professions in the United States. If large brokerage firms can retain a much higher percentage of the commissions and fees, that clearly puts a lot more money to their bottom line.

In addition to the reasons listed above, there are other reasons that brokerage houses have increased the pressure on their brokers to convert their accounts to flat fees in the last few years. The three year bear market that started in the spring of 2000 has put enormous pressure on the bottom lines of the major brokerage firms.

- Trading activity is down.
- Commission income is down.
- Mark ups, mark downs, and spreads are down.
- Margin borrowing is down.

These are all tremendous profit centers for brokerage firms. So what is one of the solutions? Convert everyone to flat fees. Let's face it - with billions and billions in brokerage accounts, making 1% to 2% a year, on even otherwise inactive accounts, is a very lucrative business plan for the brokerage houses.

There is little doubt that converting millions of investors and millions of accounts to flat fees or wrap fee accounts is definitely in the best interest of the brokerage firms. As I pointed out in the book <u>Brokerage Fraud – What Wall Street Doesn't Want You to Know</u>, this flat fee pitch is in many ways a scam. For millions of investors, this compensation setup is not in their best interest. The remainder of this article addresses why and when flat fee accounts may not be in your client's best interest.

Flat Fee Accounts Marketed as a Commission/Fee Saver

Let me touch upon the marketing of these flat fee accounts. One of the biggest hypocrisies relating to these flat fee or wrap fee accounts is how they are being marketed to many investors. The brokerage industry and their brokers are telling many investors that these flat fee type accounts are in the best interest of the investor because there no longer will be a conflict of interest as it relates to commissions. Second, they are often marketed as a commission savings to the client. As you will see below, far too often these claims are just patently false.

For a large percentage of investors, their accounts have never generated 1% to 2% in commissions in the first place. So when a broker and his firm talks a client into converting to a flat fee account charging 1% or 2% a year, this is not only not a cost savings, it is a cost increase!

Should an Investor be Paying 1% to 2% a year to a Broker?

Even if an investor's account was producing 1% to 2% a year in commissions, it probably shouldn't have been. Even in the boom-boom years, it never made sense for investors to be paying 1% to 2% in commissions and fees on an annualized basis. There are a myriad of options and opportunities for investors to have their money managed or even to trade on their own for a lot less than 1% to 2% a year in commissions and fees. Mutual funds, professional investment advisers, index funds, and the various exchange traded funds are just a few examples of how many investors can have their money managed or invested for a lot less than 1% or 2% a year.

Or think of it this way. To some degree the cream rises to the top in the securities industry. If there is a stockbroker who has a proven track record of making above average returns for individuals, he will eventually be making millions of dollars in running his own mutual fund or his own hedge fund, or he'll be a very high paid individual managing money on a professional basis. The most successful, most experienced, most seasoned individuals are running billion-dollar mutual funds or similar products. Investors can invest their money with these folks and the vast majority of the time, the client's average management fee is going to be somewhere around 1% and the maximum fee would be 2%. So it's not difficult to question the advisability of an investor paying the same 1% to 2% to a local stockbroker. Has this local stock broker been managing money on a discretionary basis for 20 years? Does he have a documented, proven track record in good and bad markets? Are his management style and investment parameters formalized and in writing for your review? Probably not. So why should an investor pay the same amount of annual fees when there is truly little comparison?

1% to 2% for Fixed Income Accounts

My strongly held opinion that most investors shouldn't be paying fees of 1% or 2% to a year to their local broker is intensified when it comes to those individual investors who have the majority of their money in fixed income investments. No one would argue with this premise in the summer of 2003 when even long-term bond rates have barely yielded 4%. But the reality is that this was just as true over the last decade when bonds and other fixed income investments produced yields that were in the mid single digit range. The math has just never made much sense. Additionally, fixed income investments such as long-term or mid-term bonds simply do not need that much active management. A 1% to 2% a year management fee is difficult to justify. Just as the majority of bond mutual funds charge less than their comparable stock mutual funds, the ethical thing for firms to do is to charge a much lower flat fee on a pure fixed income account.

With interest rates being what they have been the last few years, if an investor is paying 1% to 2% a year on even a conservative fixed income portfolio, after taxes and inflation there is a reasonable chance the investor will be left with a negative return. Likewise, keep in mind that if your client has a percentage of her portfolio in money market funds or similar investments, you'd better make sure that there is not a management fee on top of that money or that's a truly bad deal.

The Double Dip

Double dipping can be a good thing if you're talking about ice cream. But when it comes to paying commissions and fees, it is nothing but a drag on your client's investments. As a matter of fact, all commissions, fees, markups, markdowns and any other charges assessed against your client's portfolio are characterized as "capital impairment." In simple terms, what that means is that before an investor can make any money in the account, he has to overcome the costs to have the account managed and traded. This is the same concept used when performing a churning analysis – the cost equity ratio is what rate of return the investor would have to make just in order to break even with all of the costs in the account.

One of the single biggest problems with flat fee accounts is that the investor's portfolio might get double dipped. For years brokerage firms have been telling investors that even if the investor's money is put in mutual funds that they need to pay the stockbroker and the brokerage firm to monitor their mutual funds. Maybe the same individuals should be hired to watch the forest grow. We all know that the forest will grow just fine and we don't need individuals to stand around watching it grow. It's not a lot different for mutual funds. As I stated earlier, many of the best and most experienced money managers are managing the money of the top respected mutual funds. Why do you need some broker watching over their shoulders? 90% of the time, it was the broker who recommended that your client put his money in this mutual fund in the first place. So he must have confidence in the mutual fund manager. Most professionals will agree that managed money in mutual funds and similar products shouldn't be switched around very often in the first place. Yes, there are needs like evaluating portfolios and reallocating funds, but not on a short-term basis. You paid your brokerage firm commissions to buy these loaded funds in the first place; you should not have to pay them again every few years to give you a review.

In an October 1999 speech given by SEC Chairman Arthur Levitt, he stated "Over time, expenses and fees can really add up. On an investment held for 20 years, a 1 percent annual fee will reduce the ending account balance by 18 percent."[1]

And to make matters worse, at many brokerage houses the firm has a real conflict of interest in this proposal because not only is the broker being paid to oversee the funds, but he has sold your client in-house funds. So your client is also paying the same firm to manage those funds. That's a triple dip, so to speak.

There are many brokerage firms that do not charge their flat fee on top of managed accounts like mutual funds and annuities. This is the way it should be. But as you'll see later in this article, they still rake in extra commissions on these products.

Margin Use in Flat Fee Accounts

Conflicts have a tendency to raise their ugly heads in the use of margin. Once a broker has talked your client into a fixed fee account, he can double his annual fees by convincing your client to margin up his account. You see, brokerage firms charge their flat fee based on the account value, not on the account equity. For example if your client had an account into which he deposited $100,000, and the brokerage firm charged him 1% a year, the annual fee would be $1,000. But if your broker convinces your client to use margin to buy more securities, your client's account value could swell to between $200,000 and $300,000. Your client would pay, and conversely your broker and firm would reap, an additional $1,000 to $2,000, double or triple what the broker and firm made without the use of margin. It might not seem

[1] "Financial Self-Defense: Tips From an SEC Insider," Boston Globe's "Moneymatters" Personal Finance Conference, Boston, Mass., October 16, 1999; http://www.sec.gov/news/speech/speecharchive/1999/spch305.htm.

like a lot on the surface, but for brokers and brokerage firms who have hundreds of millions of dollars in these flat fee accounts, the use of margin can increase the commissions and fees significantly.

Realize also that at some brokerage firms, such as Merrill Lynch, stockbrokers actually pocket a component of their client's margin interest, so there may exist additional incentives for brokers to recommend margin.

There is yet another big conflict of interest when it comes to using margin in general and specifically in flat fee accounts. The interest rate that the brokerage firm charges your client on his margin balance is much higher than what the brokerage firm is charged for lending your client the money. The margin interest that the brokerage industry takes in every year is a huge profit center. The irony and conflict is that while margin interest boosts the revenue of the brokerage industry, margin use invariably increases the risks to an account.

Commission Kicker – A New Jaguar

At far too many brokerage firms, there is a policy that allows the stockbroker to have an investor's account set up on a flat fee basis but when the broker has some need for extra commissions, he can just sell the investor a loaded product. Eventually the regulators will get around to addressing this incredible conflict of interest, but not yet.

You may be wondering, "How can they do that? Firms tell investors that flat fee accounts are in their best interest because they wipe out the conflicts by eliminating the commissions!" Au contraire! And what makes matters worse is that the products that the brokerage industry has singled out for your client to not get the benefit of a flat fee are the very investments that pay the highest commissions to the brokerage firm and the broker. This is obviously not a mistake.

So instead of lessening the conflicts of interest, as advertised, the brokerage industry has in fact increased the conflicts of interest. The firms and their brokers convince their clients to pay them a high annual fee. This way the brokerage firm and the broker are assured to get a steady flow of fees. But when the broker's commissions are down, or when he has his a payment due on a new Jaguar, or it is Christmas time, the brokerage firms allow the broker to pad both the broker's and the firm's pockets with high commission products such as loaded mutual funds and annuities.

Even at the brokerage firms that do not charge clients the 1% or 2% in addition to what the mutual fund or annuity charges each year to manage the funds, the situation still is ripe for when your broker is short on a house payment, to just sell your client a loaded product.

Why Would a Broker Actively Trade a Flat Fee Account?

The above sections have shed some light on what would motivate a broker to actively or excessively trade a flat fee account – markups, markdowns, spreads, and margin interest. There may also be soft dollar and order flow payments that also make it profitable for an account to actively trade. Finally, be aware that some flat fee agreements contain limitations on the number of trades that get the benefit of the flat fee, after which additional fees kick in.

The industry has just come off of three years of leaving investors holding the bag. In the late nineties, the balance sheets of brokerage firms swooned while compensation for executive officers, investment bankers and brokers was astronomical. Did the major brokerage firms analysts who were making millions of dollars a year ever consider who was inevitably paying their salaries? Did the brokerage firms really earn their commissions and fees - be they flat fees or regular per trade commissions for their advice? There are a variety of ways that your client's flat fee might morph into a fat fee and depending on the amount of these commission kickers and other incentives, your client may well have gotten a bum wrap! The sad reality is that flat fee or wrap accounts can be a hotbed of conflicts where you would least expect them. Now you know.

Douglas J. Schulz is a Registered Investment Advisor, a Certified Regulatory Compliance Professional and a securities fraud expert witness. He has been in the securities business 23 years. The name of his Colorado based company is Invest Securities Consulting, P.C. He is co-author of the highly acclaimed book "Brokerage Fraud – What Wall Street Doesn't Want You to Know" available at Amazon.com. Mr. Schulz's website is www.securitiesexpert.com.