Kitces: The secret formula to setting fees

By Michael Kitces
Published October 20 2016, 11:58am EDT

With the rise of financial planning as a standalone service, an opportunity comes for advisers to charge standalone fees.

The good news: This flexibility opens up new segments of consumers to receive planning advice, regardless of their available assets to manage. The bad news: There's no consensus about the right framework for determining what advisers should charge, or how to structure their fees.

Consequently, it's challenging to figure out what the right price should be for any particular client. Nonetheless, there are several reasonable approaches for determining you're your financial planning fees should be. Here's how to do it.

FEE-FOR-SERVICE PLANNING

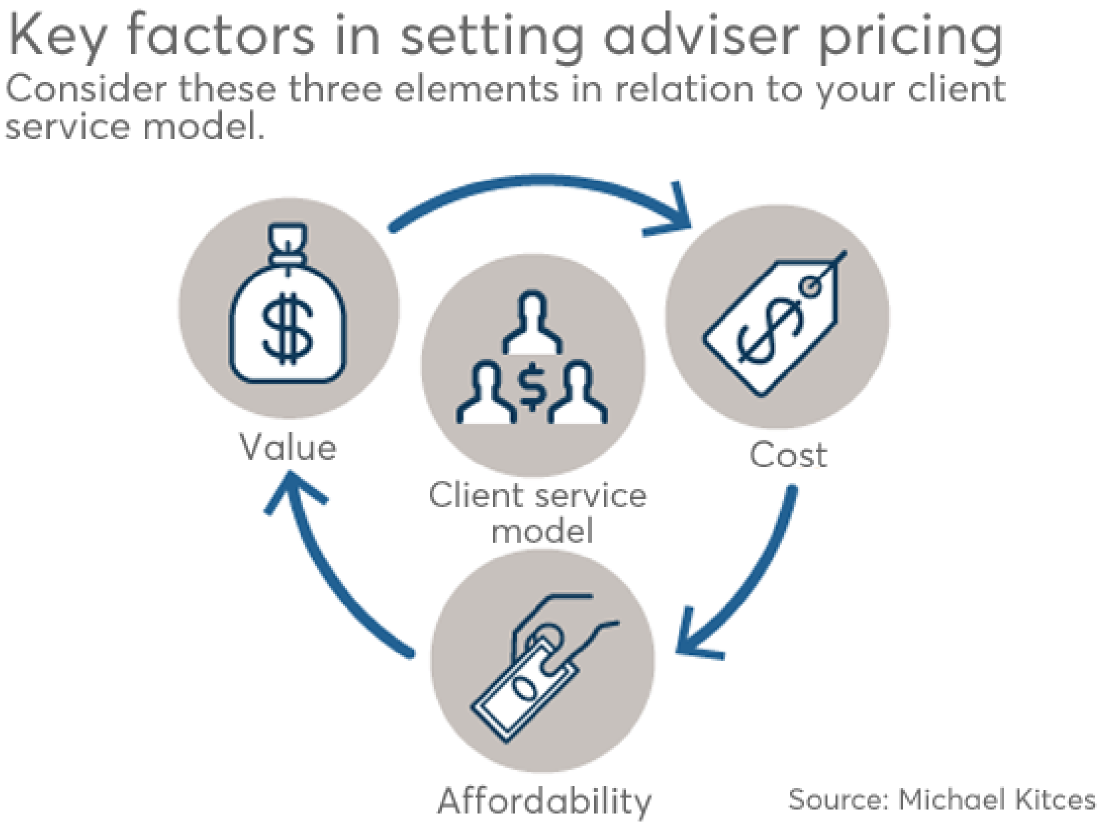
Over roughly the past 15 years, the rapid ascent of the assets under management model has proved popular. The good news of this business model is that it's fairly easy to look at what other advisers charge to manage a portfolio, and set a "reasonable" price. Over the past decade, advisers have converged on a common 1%-of-AUM rule of thumb.

By contrast, with the ongoing rise of fee-for-service planning, where consumers pay only for the advice itself, there is far more flexibility for advisers to set their own pricing. This makes it feasible to accommodate a wider range of clientele than the AUM or product-centric models permitted.

> ***The good news of this business model is that it's fairly easy to look at what other advisers charge to manage a portfolio, and set a "reasonable" price.***

The downside, of course, is that so much flexibility means there are no good rules of thumb about what a typical fee should be.

Nonetheless, the reality is that for any planning service model the adviser might deliver, the pricing model must ultimately balance three elements: what clients can pay (i.e., affordability), what the advice is worth to them (i.e., value), and the expenses for the adviser to deliver it (i.e., cost). Each of these three key levers — cost, affordability and value — can be used to set the appropriate pricing model.



CHARGING BASED ON COST

Ultimately, all advisers are constrained by time. Those who get paid for their advice are selling access to their time as an expert.

Accordingly, like many fee-for-service professionals, one of the most straightforward ways for an adviser to price services is to set a price on your time.

For instance, if you've determined that providing all the client deliverables on your annual planning service calendar — including meeting twice per year, in-between check-in calls, answering client emails and other support services — will take 10 hours per year, and you value your time as a professional at $150 per hour, then you need to charge at least $1,500 per year for your services.

Notably, how you generate that $1,500 of client revenue may vary by the pricing model you use. Perhaps an adviser will still utilize an AUM model, and simply have a $150,000 asset minimum at a 1% AUM fee. Or the adviser could simply charge a $1,500 annual retainer, or break it into a monthly retainer of $125 per month instead.

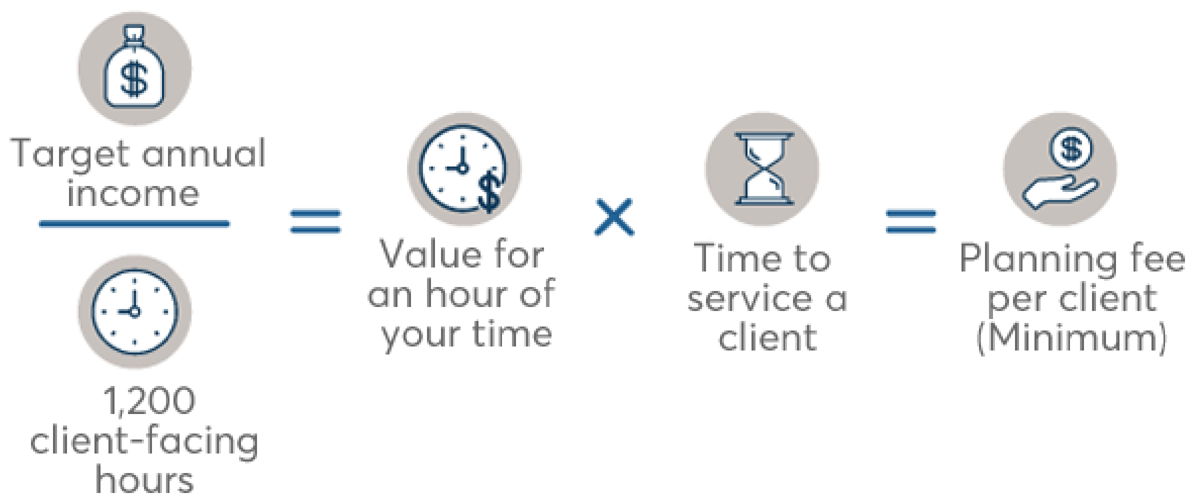
> ***One of the most straightforward ways for an adviser to price services is to set a price on your time.***

Regardless of how the fee is billed, the driving factors would be the anticipated 10 hours per year of service work for clients, and the adviser's targeted value for those hours.

But how do you determine this targeted value? A simple approach is to take a desired income level, and divide it by either 2,000 hours — roughly the number of working hours in a year — or perhaps by 1,200 hours, which is more aligned with the realistic number of client-facing billable hours (given the other non-client-facing business obligations an adviser typically manages).

Overhead costs notwithstanding, if the adviser's goal is to earn $120,000 per year, he/she must charge at least $100 per hour for those 1,200 hours of client-facing time. If the goal is to earn $250,000 per year, the hourly rate would be $208 per hour.

Key factors in setting minimum financial fees



Source: Michael Kitces

Notably, it's challenging for many advisers to determine how much time it may take to service each client. The wider the range of clients — i.e., the less focused and niche-oriented the adviser — the more difficult this can be.

Conversely, advisers focused on a specific niche — who formulate a service model customized precisely to that niche — will have the most consistency in time-to-service, and therefore can price the most effectively. Otherwise, advisers must devise a complexity-based pricing model, which attempts to determine the requisite number of hours to service the client's needs based on how complex their situation is.

CHARGING BASED ON AFFORDABILITY

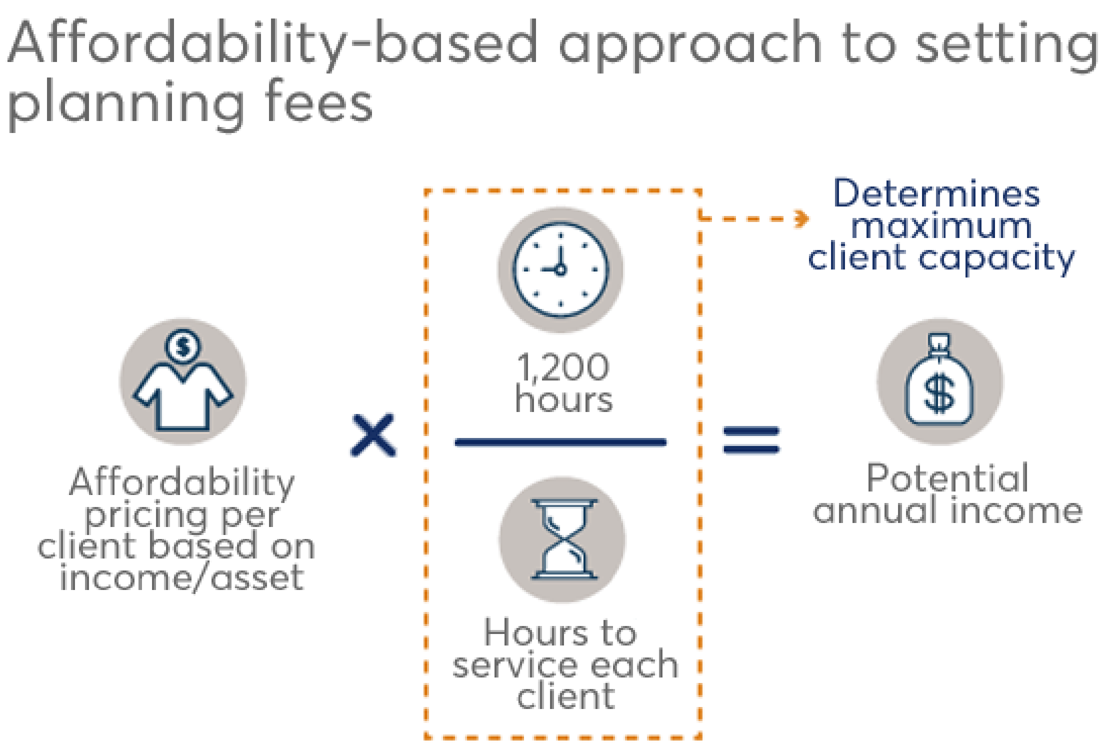
An alternative approach is to base costs directly on what a client can afford, and then determine the services that will be provided in a cost-effective and profitable manner. This ensures that the adviser doesn't set a price that fits their personal income goals, but isn't affordable to the target clientele.

The wider the range of clients — i.e., the less focused and niche-oriented the adviser — the more difficult this can be.

Fortunately, with pricing set as a percentage of the portfolio, the cost of the adviser's services scale naturally to the size of the assets, ensuring affordability. Presuming a 1% AUM fee, a $1 million portfolio pays $10,000 and a $3 million portfolio pays $30,000. The larger portfolio pays more because it presumably can afford to pay more.

On the other hand, some advisers have been experimenting with affordability-driven pricing models that aren't based directly on the size of the portfolio alone. For instance, the Planning Center, of Moline, Illinois, uses a model of charging 0.50% of net worth plus 1% of the client's income to set planning retainer fees. And we've found that several advisers in the XY Planning Network have begun to set their retainer fees at a level that approximates 1% to 2% of the client's annual income.

Affordability-based pricing does not, however, provide a free pass to charge those with higher income, assets or net worth a higher fee. It's still essential for the adviser to deliver a relevant and valuable advice service at that price point, or else clients may not sign up at all. It's also necessary to ensure that the services being offered, relative to the total price, still allow the adviser to be paid appropriately.



Source: Michael Kitces

Of course, even the adviser who charges based on time must still affirm that the service is deemed affordable by the client. Nonetheless, there's a fundamental difference between pricing based on time, and pricing based on a formulaic determination of what might be affordable — e.g., 1% of assets, or 1% of income, or 0.5% of net worth, etc.

CHARGING BASED ON VALUE

In both the prior methodologies, pricing is based on the adviser's cost of time, or what the client could afford to pay. Neither is based directly on the perceived value to the client.

Of course, if clients don't perceive value in the service, clients won't pay. Still, in a broad range of other industries, a value-based pricing approach has grown popular in recent years, to more directly tie the price of its service to its perceived value.

> ***In both the prior methodologies, pricing is based on the adviser's cost of time, or what the client could afford to pay.***

For instance, the fact that the value of something may be perceived as higher than its raw costs are why brand-name drugs cost more than generic drugs, and why Apple can sell a smartphone for about $600 when you can get a model with substantively similar features for one-third of that amount or less.

Value-based pricing has also grown popular in service industries. It's the lawyer who sets fees based on the anticipated size of the lawsuit or settlement, or the accountant who prices tax strategies based on a percentage of expected tax savings.

The challenge of value-based pricing, though, is that perceptions can be difficult to measure. To establish premium perceived value, it's important to define a niche for your specific service.

The AUM model is actually a version of value-based pricing. Clients can do more with, and pay more to, an active manager, and are willing to pay three times the fee on a $3 million portfolio than they would on a $1 million portfolio precisely because the investment manager is providing their investment value on all $3 million instead of just $1 million.

For a planner, one of the most straightforward mechanisms for value-based pricing is to look at the value of the client's time. The calculation is not what the adviser's time is worth to provide a service, but rather the value to the client of not having to perform the service themselves. The more the client values their time, the greater the perceived value of the service. For clients who value time even more highly than the adviser does, this represents a natural value opportunity—and for the adviser, an invitation to charge higher fees.

For instance, imagine working with senior executives or business owners who value their time at $1,000 per hour. With such clients, an adviser who charges $500 per hour would be perceived as a huge value, even if that fee is three times higher than the adviser's own valuation of his/her cost of time.

To establish premium perceived value, it's important to define a niche for your specific service.

Such a value-of-time discrepancy isn't solely the domain of ultra-high-income people; it also resides among clients who simply place a premium value on their personal time.

This approach once again requires offering a highly focused service to a relevant clientele—not only because it won't work unless it's really offered exclusively to those who actually value their time so highly, but also because it's still possible for the adviser to deleverage the value of their own time if it takes them too long to provide their services. In other words, the client may value their time at $300 per hour, but if it takes the adviser three hours to do what the client could have done in one hour, everyone loses.

Nonetheless, of the three models discussed, a value-based pricing approach offers arguably the greatest potential to realize drastically higher fees. Why? It creates pricing and value opportunities that go beyond just determining a fee based on adviser costs or client affordability alone.

In the end, any pricing model must still bring together the key elements of a service that the client can afford and value, and that the adviser can deliver profitably given his/her cost of time and any overhead costs.

Nonetheless, pricing can be built — and communicated to the client — around any of the three pillars of cost, affordability or value. Each may be relevant to different types of clientele, and will lead to different conversations about the cost of the adviser's advice.

So what do you think? How did you determine the pricing for your financial planning services? Are you considering a change to your pricing based on any of these approaches? Please share your thoughts in the comments below.

Michael Kitces

Michael Kitces, a *Financial Planning* contributing writer, is a partner and director of wealth management for Pinnacle Advisory Group in Columbia, Md., co-founder of the XY Planning Network and publisher of the planning blog Nerd's Eye View.

More from this Author

How the IDGT strategy can help clients avoid estate taxes

Kitces: Is the Broker Protocol being undermined?

Kitces: The pitfalls of assessing clients' risk tolerance

Comments

Login or Register

Voices The tech game is changing, so are the players

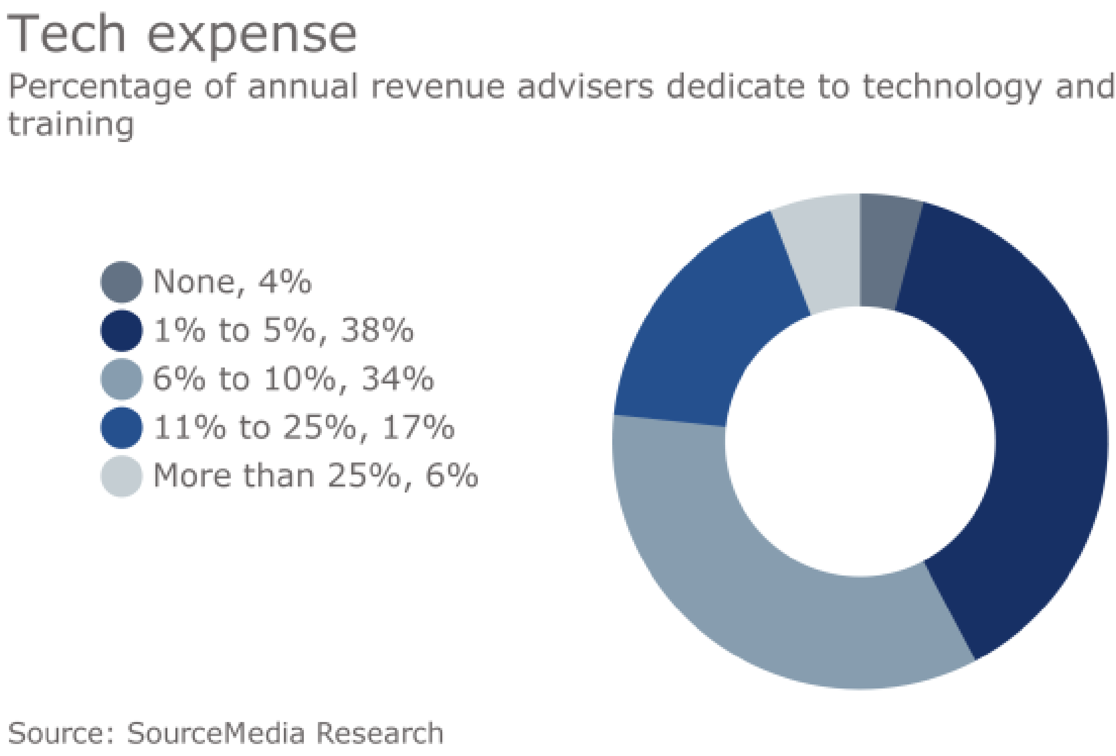
By **Chelsea Emery**
Published December 01 2016, 11:14am EST

More in **Technology**, **Wealth management**, **Investment technology**, **Joel Bruckenstein**

Print | Email | Reprints | Share

It all starts in January. Just after we release the results of our annual Tech Survey in December, *Financial Planning* editors, reporters and data experts begin discussions anew on how we can make the following year's in-depth examination of digital trends even more compelling. But even with our early start, it's the questions we add to the survey at the last moment that often reveal some of the most the most exciting, insightful or disturbing insights.

“This is the first year we asked the age of the technology decision-makers,” columnist Joel Bruckenstein, who wrote this month’s feature, “Future Ready,” tells me. “That number came in a bit lower than expected.” Indeed, 17% of our survey respondents fell in the 25-to-34-year-old age range.



This generation, raised on iPads and text messages, is likely to “do something very different in regards to purchasing decisions,” Bruckenstein adds. “I think it indicates a healthy trend of people who are more tech savvy taking the reins of the decision-making progress.”

Perhaps this younger cohort will be more willing to recommend the offerings of start-ups, or abandon products more quickly when they become outdated. Adding this query to the 2017 Tech Survey means we can report back next year on whether our hunch was true.

This year, more than 500 respondents shed light on everything from how much of their annual revenue is dedicated to technology to what CRM products they are abandoning in droves. (Hint: In 2013, ACT commanded a 9% market share in our survey. This year? Usage fell to 3.3%.)

MoneyGuidePro: A New Version Rockets Out of the Gate

New Tool Promises Fresh Approach to Risk Analysis

Tech Tools to Streamline Compliance

"There's always something that jumps out of the data that's interesting — but it's not always the same thing," Bruckenstein says.

The Tech Survey also asked for the first time this year if respondents' firms had been the target of a cyberattack. About 14% said yes. "Cybersecurity has become more of a front burner issuer over the last six to nine months," Bruckenstein says.

Sometimes we were surprised by what hadn't changed.

"I expected to see the number of advisers using a robo solution to be slightly higher than it is," Bruckenstein tells me. Will the numbers be higher next year with all those 25-year-olds taking the reins of the tech spending decisions? I look forward to finding out.

Chelsea Emery

Chelsea Emery is Editor-in-Chief of *Financial Planning,* SourceMedia's flagship brand covering wealth management.

More from this Author

Using real estate to jump tax hurdles

Exciting … or intrusive? New tools will let advisers monitor client spending

Editor's View: A Witches Brew

Comments