



THE FAIRNESS OF BUYING POWER AND EXCESSIVE FEES

The real story behind all this pressure on financial services compensation is largely a lack of understanding and has the effect of letting bad actors off the hook while punishing the best and the brightest. Maybe this explanation will encourage both policymakers and practitioners to examine and revise their approach to doing the right thing.

We start with the understanding that:

If you buy a lot of anything you can demand and get a lower price!

If you pay an exorbitant price for something then prices are excessive!

While my egalitarian friends may not like this buying power, it is nonetheless an inescapable fact. Buying power is a naturally occurring phenomenon and trying to avoid it is a losing proposition. It is also natural for sellers to seek the highest price possible and for prices to rise as demand grows.

Most areas of commerce use buying power as only one of several factors to determine price. The main factors include cost of goods/services, guarantees, convenience, quality, image, reputation and the value of the product or service. These and similar factors determine the MSRP before buying power influences the price.

We consider a price derived this way to be fair.

A price that is significantly higher than others with identical factors would be considered excessive.

Nowhere is buying power more relevant than in the investment community. With investments, we often find that buying power is the only determinant of the price (more often referred to as "fees and expenses" or "basis points"). These euphemisms for price are used to make sure we don't confuse this "price" with the "market price", which reflects the value of the investments themselves.

Investment services most often charge basis points that bear no relationship to the service being provided in today's world. The approach of charging a share of the goods (basis points) originated at a time when acquiring an investment meant a laborious camel ride across a hot desert with a high risk of being robbed. So it made sense to charge more for a long and dangerous trip and for more valuable cargo.

This approach to pricing seems irrational today when a trade involves typing in a ticker symbol or CUSIP number!

It has been argued that basis points represent a price that reflects the cost of infrastructure and services needed to manage assets and to advise investors. That argument is weak since these costs are not proportional to the investor's assets and the charges bear no relationship to the work involved.

The price is simply based on buying power and little else. Yes, investments is a world where buying power is all that matters. Success or failure doesn't matter. Quality doesn't matter. The more assets you have, the lower the basis points will be.



The result is that in real dollars, large investors pay far more than small investors for identical services. Even though their basis points may be lower, the bottom line is 1% of a million dollars is a lot more money than 2% of a thousand dollars. Large investors pay a lot more! This would suggest that it is the large investors who pay the excessive fees.

Is this fair?

Are fees excessive?

Is the government working on behalf of the rich as they seek to eliminate excessive fees?

The emerging practice of assessing fairness based on the average of what others pay actually compounds the problem by putting even more emphasis on buying power. This practice ensures only that all investors with the same buying power get to pay the same price, thus completely ignoring the value received for the price paid.

Yes, the benchmark that is an average of what others pay sets a standard that every investor with \$1 million should pay the same fee, regardless of the demands made by the investor or the quality of services rendered. The effect of this standard is to lower fees and eliminate services to avoid losing business, losing money and leaving small investors behind. It does nothing to curb practices that take advantage of the unsuspecting.

This is not to say that basis point pricing cannot be fair to practitioners and investors. Pricing should reflect the relevant factors of costs, risk, profit and buying power.

The following example shows the harm that current practices can do to all involved and how merely examining the facts in a different way leads to a prudent decision that is to everyone's benefit.

This example illustrates a 401(k) plan with 250 participants and \$10 million in assets. The plan pays fees of 85 basis points, which, based on averages is perfectly normal. The plan fiduciary is offered advisory services that cost the plan an additional 60 basis points and would create an excessive fee condition, again based on averages. The obvious answer is, no thanks!

But wait, we have not looked at the cost (in dollar terms) or what the financial benefits are.

Using the DALBAR [Reasonableness System](#), we estimate the following financial effects for the retirement accumulation (compounded over the working life) of a typical participant:

Cost of advisor @ 60 basis points	(\$119,887) (14% of total)
Benefits:	
Reduced investment errors (1%)	
Increased savings/deferral (1%)	
Earlier/continuous participation (10%)	
Reduced leakage from loans/withdrawals (10%)	\$637,146 (73% of total)
Total effect	\$517,259 (59% of total)

It becomes clear from the example that what appeared to be an expense of \$119,887 in reality is a net benefit of over half a million dollars! The fiduciary decision is really based on whether achieving the stated benefits are reasonable.

Correction begins with how the price is set and what is considered in determining if it is excessive. In short, what is a reasonable price?



Fair and rational pricing starts with practitioners assessing the worth of the services being rendered. This is a dollar and cents valuation of what is required to deliver the service and make a profit. After determining the worth, this dollar value can be converted to basis points to maintain the well-established practice.

A similar dollar determination is required when evaluating fees. Investors should not accept basis points without knowing what the actual dollars are. Fiduciaries should always base decisions on the dollar value of the basis points. Regulators should examine compensation paid in dollars and cents. The courts should demand to know what the real dollars are. The media should not be trapped into a pointless comparison of basis points and divert focus away from the money.

Focusing on the dollars makes finding true excessive fees more viable. Here is what would happen if instead of being alarmed by all who pay over 100 basis points we examine all who charge clients over \$1 million dollars.

Using the 100 basis point criterion a regulator would have the nearly impossible task of searching through the millions of "loss leader" clients to find a very few genuine over-charges. This is not where the wrongdoers work.

Identifying practitioners that earn over \$1 million will predominantly yield hard working and talented experts but it is also far more likely to turn up an unscrupulous cheater!

Two famous quotes come to mind when it comes to catching crooks. We can learn from what Willie Sutton (the thief) supposedly said, "I rob banks because that's where the money is", and from Deep Throat who is believed to have advised the Watergate investigators to "Follow the money".

These quotes illustrate that it is far more likely to find the crooks where the money is! And crooks won't call attention to themselves by charging excessive basis point fees.