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Advice from a Broker-Dealer: Not as Affordable as it Appears to Be

Broker-dealers and their lobbyists routinely claim that advice from a broker-dealer is more affordable than advice from an investment adviser, making brokerage services a more attractive option for low- and middle-income customers. There is no doubt that the lack of transparency around broker-dealer costs makes their services appear more affordable, particularly to financially unsophisticated retirement savers. A look beneath the surface quickly reveals, however, that when the total costs of investing are compared, retirement savers who get advice from a broker-dealer will in most cases pay at least as much, and often much more, for a lower level of service.

The following are a few concrete examples to help illustrate this point. We first compare the costs retirement savers pay for the services of brokers and advisers in several common scenarios. Then we look at the relative costs of investment products recommended by broker-dealers and investment advisers. It is only by looking at the total cost of advice and investments that a fair comparison is possible.

Paying for Advice

Among the most common recommendations by broker-dealers and investment advisers alike is the purchase of a mutual fund or variable annuity. The broker may be paid for his or her services in selecting that investment through an up-front sales load or, increasingly commonly, through a 1 percent 12b-1 fee that is included in the annual operating costs of the fund. The adviser will typically be paid based on a percentage of assets under management or, less commonly, through an hourly fee or engagement fee. How do these costs stack up?

- The 1 percent 12b-1 fee that the investor pays as part of the fund's annual expense ratio to compensate the broker is comparable to the 1 percent asset under management fee charged by many investment advisers on accounts under $1 million in value.
- The investor may pay that on-going 1 percent 12b-1 fee to compensate the broker year after year for as long as he or she holds the fund, even though the broker disclaims any obligation to provide on-going advice or account management services.
- In contrast, the 1 percent fee paid to an adviser often includes not only on-going advice and account management, but also in some cases comprehensive financial planning.
- Moreover, the adviser has an affirmative obligation as a fiduciary to act in the best interests of the investor when making recommendations, while the broker-dealer is subject to a weaker "suitability" standard. As discussed below, that has a direct impact on the cost and quality of investment products recommended by advisers and brokers.

[1] Commissions of as much as 8.5 percent are permitted under FINRA rules but are no longer common.

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Some broker-dealers charge for their services through an up-front sales "load" or commission of as much as 5.75 percent on the mutual funds they recommend.[1] While large investors can often get discounts on these commissions, middle income investors with smaller amounts to invest are more likely to pay the maximum load.

- Depending on the size of the investment, that sales charge can amount to paying a lot for a few hours work. For example, an investor who pays a 5 percent sales load on a $20,000 mutual fund purchase will end up paying $1,000.
- If that same investor got a recommendation from an adviser who charges an hourly fee of $250-$300 per hour, they would likely end up paying roughly half as much. Here again, that adviser would have a fiduciary obligation to act in the best interests of the client, while the broker would not.
- Robo-advisers offer even lower cost services to individuals who have modest amounts to invest and are comfortable working through an automated, online account.

Paying for Investment Products

But the fees that retirement savers pay for the services provided by broker-dealers and investment advisers are just one part of the total costs that these individuals pay. They also pay operating costs and other expenses associated with the investment products that are recommended.

- Advisers will typically recommend no-load funds, where price competition has kept operating costs low.
- Operating costs among broker-sold funds are often significantly higher, even after the costs of compensating the broker are subtracted out. This is likely explained by the lack of effective price competition in a market where funds compete to be sold, not bought and do so in ways that drive up costs to investors.

If the broker recommends a variable annuity rather than a mutual fund, the costs are likely to be much higher still.

- In addition to any up-front sales load or 12b-1 fees charged to compensate the broker, fees on variable annuities can include mortality and expense risk charges, surrender fees, annual operating costs of the underlying investment options, and any additional fees charged for the various riders that may be offered.
- While lower cost options exist, broker-dealers operating under a suitability standard have not been held accountable for considering costs when making recommendations to their customers.

Ultimately, it is only in the relatively rare circumstances that a broker recommends investments exclusively in individual stocks that the costs of brokerage services are clearly lower than the annual fees associated with an advisory account. But the typical middle income retirement saver simply does not have the resources to get adequately diversified investing in individual stocks, so this lower cost option is generally not available to them. For these individuals, advice from a true adviser will often be a better deal than a sales pitch from a broker masquerading as advice.

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