Commissions vs. Fees

Insurance commissions may have been given a bad rap in today's best-interest-driven world. But are they really hurting clients?

VIG-OR-ISH ***noun*** **(aka. "Vig")**

1. **an excessive rate of interest on a loan from a moneylender.**
2. **the percentage deducted from a gambler's winnings by the organizers of a game.**

What could more perfectly describe the relationship between broker-dealer reps and advisors with their clients? Equity purchases and managed portfolios are at best calculated, and often "very well-informed bets" on what might happen in the future. For many of these bet-takers, the results are much more likely to be riding a wave as opposed to charting a carefully considered course.

Never Take A Loss

With shocking regularity, news stories appear about some random game by stark amateurs who can make market picks that outperform financial professionals of the highest stature. Since Barton Malkiel's *"Random Walk Down Wall Street"* was first published in 1973, we have seen a lot of fun around the notion of a blindfolded monkey beating the professionals.

A few weeks ago, *The Wall Street Journal* reported a group of their staffers threw darts at a list of stocks and outperformed a group of elite financial professionals. The dart throwers posted a nice profit while the group of very high-flying professionals posted a loss.

Famously, Warren Buffet's Rule No.1 is "Never lose money." His Rule No.2 is "Don't forget Rule No. 1." Yet we know that betting on the market results in losses with such frequency that a blindfolded monkey can do better than premier Wall Street professionals.

To be fair, the issues and considerations are complex, but the bottom line is the **vigorish** paid to purchase speculative instrument or to have an advisor manage a portfolio is a lot like placing a pretty risky bet. You could pay the **vig** and points on top through losses.

This risk is amplified when it affects a family's retirement income. The amusing scenario of dart-throwing monkeys doesn't consider the reality of a decumulation strategy knocked about by sequence risk and the uncertainties of simply living life. To provide clients with the confidence that they will not outlive their money, insurance products must play a prominent, even majority, role in a retirement strategy. As part of the insurance transaction, an agent is paid a sales commission.

Commissions on Fixed Products are Wonderful Things

When a client buys an insurance contract, they are buying a specific guaranteed feature set. They are **not making a speculative investment**. Every insurance contract has underlying minimum guarantees that are known for the balance of the contract, and typically for the balance of the client's life. No equity, bond or alternative investment can say as much.

Unlike Asset Under Management fees (AUM), insurance sales commissions are not paid by the client. If the client gives an insurer $100,000, that entire amount goes to work under the terms of the contract immediately. And at that time, the client can look down the road one year, 10 years or 40 years into the future and know to the penny the minimum value of the thing they purchased. Now that's the basis of a plan. Something you can build on. A foundation upon which you can expand and grow, knowing that a base is there. And it has not cost the client one cent.

Cynics, typically politicians and fee-based advisors, contend that if commissions on product sales were not so high, products could be better for clients because the insurers could plow those exorbitant commissions back into client benefits. **That's like saying that if linemen weren't so well paid, your electric bill would be lower.**

Personally, I don't care what linemen make. I hope they do well and prosper. What I do care about is having the lights come on when I flip the switch. Without knowing almost anything about how electricity gets from a distant generating station to my microwave, I assume there are many people involved in the process and some of them are very well paid. I think most people would prefer to work with a successful, well-paid agent than with an agent who was not successful or well-paid. So, the real question is **"What does it cost the client?"**

Fee-Based Planning Has Incentive Conflicts

Setting aside monkeys with darts, this contrast of a sales commission to **AUM** fees is critical. **AUM** fees put all the incentives in the wrong place for responsible retirement planning. We often hear fee-based advisors touting that their income increases only if the value of the client's account increases. It is typical for fee-based advisors to earn a fee-based on the value of the client's **AUM**. What gets less attention is that the **client also pays if the value of their account declines**. The impact of these unending fees can be tremendously detrimental to the client particularly during retirement.

Funding retirement from portfolios based on bonds and equities is very risky. According to a report published by a major brokerage company and released in 2011 we know that there was only about a 6 percent chance of a portfolio distributing an inflation-adjusted 3 percent lasting 30 years.

In their efforts to ensure that their clients are not among the 94 percent who would fail, fee-based advisors are under pressure to perform better and better. They take more risks. Which is exactly what most retirees do not want. Studies show that about 75 percent of retirees prefer safety over return. Yet the pressures and incentives for fee-based advisors are to increase risk to maintain and grow the portfolio, so their fees can be higher. And all the while, **win or lose for the client, fee-based advisors are being paid fees.**

This is in sharp contrast to insurance agents who are paid a commission to provide guaranteed minimum benefits. The cost to the client for the services of broker-dealers and fee-based advisors can be 1 percent, or even higher, and fees would continue for the rest of the client's life. Commissioned insurance agents typically make one commission. Very often that commission is in the range of 2 percent to 5 percent. They can be higher - even 8 percent, 10 percent or more. But they are not forever, and they are never paid by the client. A 7 percent one-time commission not paid by the client looks pretty good compared to 1 percent paid by the client every year for perhaps 30 years.

In large part, this one-time sales commission is the distinction that will put guaranteed value, fixed insurance products at the front of retirement planning from a "best-interest" standpoint. The payment of a sales commission for the purchase of a specific product creates a stark distinction between what fixed insurance products provide and what investments are trying to do.

The agent has sold a specific feature set that will provide specific benefits for worried retirees. The client has purchased "certainty" and has not invested in "perhaps". The agent has earned a commission for that defined service to their client.

In contrast, the broker-dealer rep or fee-based advisor places a bet about how things might be in the future. And for that they get the **vig**. And sometimes the client pays the "**vig plus 3 percent**" or more.

Providers of guaranteed insurance products will shine and dominate when it comes to meeting the "best interest" of clients who are most keenly concerned with safety and not outliving their income.

Excerpts by Jack D. Aiken