



Professional Financial Advice:

Understanding the Manner of Compensation Is Very Important to You

The Encarta North American Dictionary describes a professional as a person who is "... business like, very competent; conforming to the standards of skill... or character normally expected of a properly qualified and experienced person in a work environment... a 'paid' occupation that usually requires a high degree of training and skill."

The mass media is awash in "How to" articles for selecting an investment advisor to be your financial professional. A consistent theme of such messages is to understand how *you* will pay for your investment advice. It is important to realize that as the *Encarta* definition explains, the professional is paid and that regardless of how that compensation is explained, *you* are the one that makes that payment.

There are several elaborate pricing methods used for charging investment clients, each, however, basically falls into one of two core alternatives: fee based or commission based. The pricing method used, should certainly weigh on your decision to employ HFG or any other firm and therefore it is important that you understand how both fee and commission based compensation plans work.

Since our founding Helmsman Financial Group, LLC has been a fee based financial advisory firm. Our belief is that for most people this is the most cost efficient and unbiased approach to meeting your financial planning needs.

In a *fee* system the client pays based on the *work performed*. Prior to the engagement, the advisor will define the services to be performed for the client and what such assistance will cost. The cost of service is based on the work done and not transactions undertaken or the products purchased. A retirement plan may be developed for a cost of \$1,000 or a portfolio may be reviewed and changes recommended for \$800. This cost for the services is unrelated to the client implementing the plan. If the client implements the entire plan or if no part of the plan is implemented, the cost is the same. The advisor's compensation is completely separate from the actual transactions done to implement the plan.

A **commission** approach, in comparison, is **transaction based**. The advisor (often referred to as the broker in this system) is paid based on the transactions done, not



necessarily for the work performed. The broker may prepare a type of retirement plan and not charge anything for it, but gets paid when the stocks, annuities, mutual funds or other investments are purchased. The costs of these transactions can be in different forms and HFG believes it is important for any prospective client to have a basic understanding regarding how these costs are assessed.

Individual Stocks and Bonds - In the case of individual stocks and bonds, the client will pay for the service in one of two ways. You may pay a commission on the transaction. This may be cents per share, or a percentage of the trade. In the second way, the trade cost is included in the price of the investment through a markup in the price paid by you.

Mutual Funds - While there are many types of mutual funds with a variety of compensation alternatives for commission compensated brokers as a category these funds are known as loaded funds. The three most common forms of loaded funds are "A share" "B share" and "C share". Regardless of which type of shares you are purchasing, the cost of such shares will always be described in the prospectus for the applicable fund. This is one reason why it is important for you to review the prospectus before you purchase a mutual fund. Briefly, here's how the three most common types of loaded fund commissions are determined.

In the case of an "A share", you pay a commission up front in the price of the mutual fund. As an example, if you purchase \$1,000 of an "A share" mutual fund having a 4% "load", the first \$40 (4%) goes as compensation to the broker and his firm with the remaining \$960 going towards the investment. The average commission paid on "A shares" is approximately 4 - 5%. While you may not see the commission broken out, this is the cost *you* pay when purchasing the shares.

With "B shares" no commission is paid upfront, instead, there is a deferred sales charge *you* pay if you sell the shares within the first few years. This charge normally is on a declining basis and lasts for 5 - 7 years. As with "A shares", the broker selling the mutual fund and his firm gets paid when your purchase is made. For the mutual fund to do this there is an additional annual charge assessed on these shares called a 12B-1 fee levied against "B shares" which reduces the net yield paid to *you* on the shares. Such a 12B-1 fee will normally be .75% to 1.00% per year and should be considered a cost to *you* in purchasing "B shares" mutual funds.

The third class of shares is called "C shares". With "C shares" you do not pay an upfront fee, nor do you pay a deferred sales fee if you sell it, but *you* do pay an additional annual fee for as long as you hold the fund.

Annuities - Annuities are an insurance product and are sold by insurance licensed agents. When you purchase an annuity, the commissioned salesperson is paid a

commission. Such annuities normally have deferred redemptions fees, similar to “B shares” mutual funds that you must pay if you redeem the annuity prior to a certain time period.

Fee versus Commission: HFG, as with most advisors, believes that the critical factor in selecting financial guidance is your comfort level with that individual and company offering the service. Selecting someone you trust and have confidence in is job one. While cost of the service should be a secondary issue, understanding compensation is an important component in doing the due diligence prior to your decision. *You* are going to pay for the service you are receiving. As an example how these costs work, let’s assume that you have \$250,000 available to put to work toward meeting your financial goals.

You first go to a fee based planner who will do a portfolio review and implement the plan with “no-load” funds (no commission), for a cost of \$1,000. There may be some small transaction fees, but they would probably be less than \$500, so, on balance your total cost would be \$1,500 to set up the portfolio.

Now if you chose to use a broker who sold you A share funds having a “load” of 4%, it would cost you \$10,000 to implement the portfolio. If you used a broker who sold you B shares, there would be no cost up front, but you would have a fee if you sold them over the next few years. In addition, you would have an additional annual 12B-1 fee of 1% or \$2,500. After five years this would be an additional cost of \$12,500. Finally if you purchased C shares having a 1.00% annual 12b-1 fee, your annual cost would be \$2,500 for as long as you owned the fund.

In every case *you* pay a fee or commission. Only the amount charged and when *you* pay it may vary. Once you understand how your advisor is compensated you can factor your comfort level with each approach into your decision making. The important factor is that you understand it is *you* that ultimately pays regardless of compensation format and that by understanding each format *you* will avoid surprises, confusion and misunderstandings

Should *you* agree with us that the fee based service approach is more cost efficient for *your* investment portfolio, please do not hesitate to contact us at 425-485-0381 to set up an appointment to discuss further how HFG can assist you in achieving your financial goals.