ADVISOR PERSPECTIVES

Fidelity's Zero-Fee Lesson for Advisors

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It's a wonderful time to be an informed investor. In August 2018, Fidelity announced two no-fee index funds. Investors can now get exposure to the global stock market for no cost. Zero.

That's a big deal.

But is it really?

Schwab is rumored to be considering a similar fee reduction. The price war in index-funds may indeed be the boon that it promises to be for investors. But for the advisors who serve them, the implications are far less sanguine.

Much ado about nothing?

Expense ratios for index funds have been dropping steadily for the last decade. Before Fidelity's announcement, investors had many options for broadly diversifying their stock and bond portfolios using ETFs with expense ratios ranging from six to 20 basis points.

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The difference between these fees and zero is insignificant to investors.

Much ado about something?

The publicity surrounding Fidelity's bold move may have significant consequences for beleaguered actively managed funds. The average expense ratio for those funds in 2017, when weighted by the amount the funds have in assets, was 0.52%

Investors might finally start asking the question they should have posed long before Fidelity's announcement: "What am I getting by paying these fees that I can't get free with Fidelity's index funds?"

The truthful answer is: "You're getting lower expected returns."

Jack Bogle famously stated, "[T]he grim irony of investing is that we investors as a group not only don't get what we pay for, we get precisely what we don't pay for."

Investors may finally understand the impact of higher fees on performance.

It's hard to beat "free."

Impact on advisor's fees

If a major fund family is offering to manage index funds without charge, what impact (if any) will this development have on advisor's fees?

Most advisors still charge a bundled fee, based on assets under management. Those advisors offer comprehensive wealth-management services, which include making investment recommendations. The bundled fee makes it difficult for investors to break out what they are charged for various aspects of the services provided.

Nevertheless, some investors may use Fidelity's announcement to press advisors to lower their fees. After all, if Fidelity is willing to manage broadly diversified index funds for no fee, is it reasonable to pay advisors a significant fee for recommending the purchase of those funds (or similar ones)?

The option of using zero-management fee funds will make it more difficult to demonstrate the likelihood of putting together a portfolio that will outperform those funds. The greater the disparity between the management fee of the funds you're recommending, and zero cost, the lower the probability of outperformance – and that doesn't take into account your advisory fee.

Advisors who demonstrate value with their investment recommendations (by using portfolios or other funds that offer prospective risk-adjusted outperformance) may not be subject to the same fee pressure.

A marketing opportunity

Fidelity's rationale for reducing fees to zero on designated funds was articulated by Kathy Murphy, president of Fidelity's personal investing business, "We look at long-term relationships with clients and we benefit from clients having a relationship of 30 to 40 years with us."

Shouldn't that be the view of your advisory firm as well? What if you took the bold move of saying you would match Fidelity and not charge clients anything for placing them in an index-based portfolio? Or charge a sharply discounted fee for this aspect of your service? You could still charge a fee for the balance of your services. There would be many options for calculating that fee, including a retainer based on complexity or an hourly fee.

It is only a matter of time before advisory firms will differentiate the way they charge from their competitors.

Fidelity set a high bar for doing so.

Dan Solin is a New York Times *best-selling author of the* Smartest *series of books. His latest book is* The Smartest Sales Book You'll Ever Read*. His sales coaching practice includes helping advisors convert prospects into clients and generating leads through videos and other elements of marketing. Dan is not affiliated with any advisory firm.*

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