BY MEIR STATMAN, Ph.D.

Editor's note: This is the sixth in a series.

I have a million dollars in my portfolio," thinks a client. "I don’t mind paying a fee for the management of stocks. Stocks are complicated and I cannot manage them on my own. But the management of bonds is easy and cash needs no management at all. Why am I paying you a fee for these?"

Financial advisers want clients to leave their periodic meetings not only with an accurate assessment of their wealth but also with a feeling of well-being, a sense that they are in the good hands of capable and caring advisers who enhance their lives. Clients want advisers who teach and inspire, advisers who promote hope and banish fear. Advisers hope that at the end of each meeting clients will understand the value of their services and the fairness of their fees. But while fees are mentioned somewhere in the documents that clients take with them at the end of a meeting, they rarely are discussed during the meeting.

Fees are difficult to discuss because they pit the self-interest of advisers against the self-interest of clients. Clients want to pay less while advisers want to be paid more. Both advisers and clients care about fairness, but all suffer the fairness bias that tilts their perception of fairness toward their own self-interest. As Linda Babcock and George Loewenstein write, teachers negotiating for salary increases compare their salaries to those of teachers in better-paying districts and conclude that the salaries offered by their own boards of education are unfair. Boards compare the salaries of their teachers to those in lower-paying districts and conclude that the salaries they offer are generous, not only fair. Differences in perceptions of fairness between teachers and boards lead teachers to strike. Differences in perceptions of fairness between advisers and clients lead clients to seek new advisers.

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People often walk away from profitable deals that seem unfair. Consider the ultimatum game. Imagine that I am holding $1,000 in cash, facing you, Michael, and you, Jane. I say to Jane: “Make an offer for the division of the $1,000 between Michael and you. But the offer is an ultimatum, not open to negotiation. You, Michael, can either accept it, in which case I will divide the money between you and Jane, as you agreed, or you can reject it, in which case I will keep the money and neither of you will get anything.”

Suppose that Jane offers a split of $980 for her and $20 for you. If you accept, you will be $20 richer. Do you accept? Many Michaels reject the deal. They say, “I would rather see my $20 burn than submit to such an unfair deal.”

Value, fees, and fairness all matter. Investors expect more than good value for their fees; they expect fair fees. Advisers must frame well both the value of their services and their fees if they want investors to accept the exchange of value for fees as fair.

Imagine that you are seeing a physician because your stomach hurts. The physician asks many questions, examines your body, provides a diagnosis, and concludes with education and advice. The examination, diagnosis, and education are free, says the physician. All you have to pay is the price of the pill you received. That would be $200, please.

Financial advisers regularly act as the physician in this story. Financial advisers frame themselves as investment managers, providers of “beat-the-market” pills, when their equally important role is that of investor managers, professionals who examine the financial resources and goals of investors, diagnose deficiencies, and educate investors about financial health.

Financial advisers are not capricious as they frame themselves as managers of investments and downplay their role as managers of investors. They know that investors find it fairer to pay for the former than the latter. While we have moved from a manufacturing econ-
omy to a service economy and now to an information economy, people still think that charging for manufacturing is fairer than charging for services and that charging for services is fairer than charging for information.

Financial advisers can choose one of two frames. They can frame themselves as managers of investments, telling investors that they can beat the market through judicious choice of stocks, bonds, mutual funds, or money managers. “What do you care if I charge you 2 percent,” they say, “when I promise to beat the market by 8 percent?” Or they can frame themselves as managers of both investments and investors, who are paid to examine the financial situations and goals of investors, diagnose deficiencies, and educate them about their financial health.

Investors are not averse to fees that they perceive as fair. Patients know that physicians who charge $200 for office visits take most of it as income. They also know that good physicians have high incomes. Yet most patients are not angry when they pay for office visits. Indeed, they are not angry even when physicians tell them that all is well and no prescriptions are needed. Why? Because they know that the real value they get from physicians goes beyond a prescription. It is expert diagnosis, expert education, and expert care.

Financial advisers take care of the entire financial health of their investors and that financial health involves the entire portfolio, stocks as well as bonds. People who care about fairness do not treat others unfairly. It is unfair to ask the staff of a computer store for a thorough education on computers and then buy the computer at a discount store. Similarly, it is unfair to ask financial advisers for education on the overall portfolio and then buy the bond portion at another place. The value that financial advisers provide is proportional to the size of the overall portfolio, and it is only fair that their fees are proportional to the size of the overall portfolio. M

Meir Statman is the Glenn Klimek Professor of Finance at the Leavey School of Business, Santa Clara University. “This series draws on my work with investment consultants and investors at Loring Ward Advisor Services,” he says. “They continue to teach me as much as I teach them.” Dr. Statman earned B.A. and M.B.A. degrees from the Hebrew University of Jerusalem and a Ph.D. from Columbia University. Contact him at mstatman@scu.edu.

References