Lifeworks

How Fees Impact Your Outcomes

BY ALEX MATHÉ-CATHALA

Your total cost, hidden fees included, is the variable with the greatest impact on your probability of success as you hire a financial advisor–assuming that they can design a sound financial plan and an appropriate investment strategy in the first place.

An endless supply chain connects the issuer of a financial claim, an entity who seeks funding, to you, an individual investor who seeks return in exchange for providing funding and bearing risk. The following is a most shortened summary of the chain as far as the average publicly traded security is concerned:

> Private or public entity seeking funding -> investment banker 1 (acting as advisor to issuer) -> investment banker 2 (acting as broker) -> active asset manager -> another broker -> active or passive mutual or exchange-traded fund -> custodian -> large financial advisory firm and/or turnkey asset management program (TAMP) provider -> risk assessment and management tool provider -> your advisor -> you.

That supply chain has been flourishing for decades now and each link has been collecting their share of the value. But not each link explicitly appears on the bill your advisor sends you. You sure foot the bill however! What with the explicit and hidden compensations of all intermediary stakeholders, the original issuer and the ultimate holder of a security find themselves paying more than two cents *every year* on each dollar the issuer raised *once*.

We believe in the potential of modern financial technology to burst the supply chain. In particular, the lower end of the supply chain, where the advisor sits, should be largely dismantled. Operating under a large national firm with unnecessary overheads as an advisor, systematically resorting to expensive fund managers, and paying for third-party risk assessment and management software has become irrelevant. In effect, Lifeworks' investment and technology teams have built our own tools to make the value chain contract to ultimately benefit you, the investor, by keeping your total fee as low as possible and thus reduce your probability of failure. In particular:

- Our hidden fees typically range from 0.00% to 0.10% on an annual basis, with a typical $1 million account paying a 0.06% hidden fee only, which sets a record low in our industry;
  - We do not use mutual funds as our investment technology allows us to intelligently select, buy, and rebalance individual securities. As a consequence, our clients do not incur mutual funds' entry costs, nor do they pay for their recurring management fees, exit fees, and periodical rebalancing costs;
  - For the same reason, we do not use ETFs except for the least expensive ones such as VTIP for example, which charges a 0.04% annual fee, that only make up a reduced portion of small accounts managed by Lifeworks;
  - We do not use third-party asset allocators (TAMPs);

The median advisor charges an explicit 1.00% annual fee for themselves and uses mutual funds and ETFs as the default building blocks of their portfolios, and sometimes TAMPs and other third-party providers. The median total fee in the industry, hidden fees included, amounts to 1.65% for a typical $1 million account.[1] The difference between

[1] 2017 Inside Information Advisory Fees Survey by Bob Veres: https://www.kitces.com/wp-content/uploads/2017/05/2017-Inside-Information-Advisory-Fees-Survey-1.pdf

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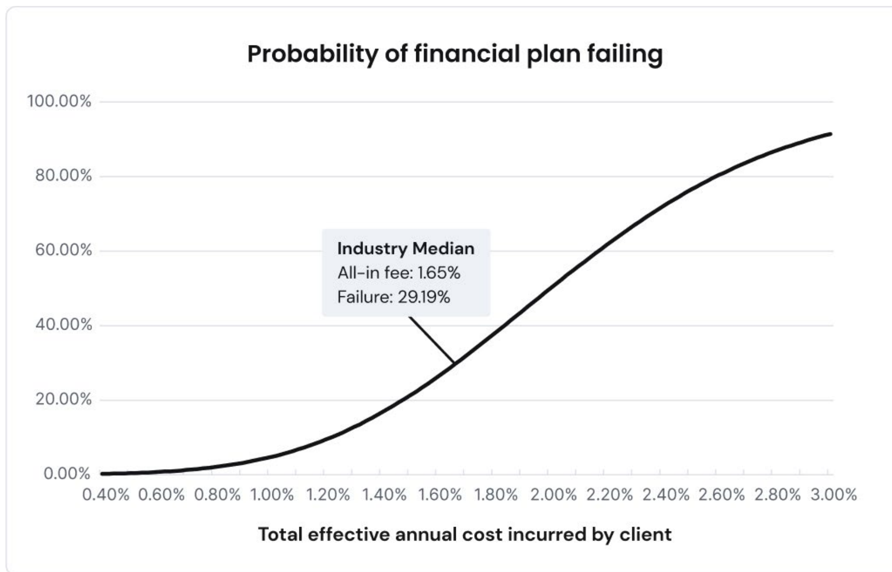
A graduate of MIT with a Master's in Finance, Alex worked at Morgan Stanley, Rothschild, and other notable investment firms. Before joining Lifeworks, he was the Founder and CEO of Aimvest Technologies, a quantitative investment technology firm helping financial institutions and advisors manage risk for their clients. Aimvest was named one of the Top 15 MIT Startups to Watch in 2020 and acquired by Lifeworks in 2021.

When Alex and his team aren't developing algorithms to augment our investment offerings, they are preparing market insights and quantitative analyses that add value to our advisors and clients.

the two total hidden costs, 0.06% and 0.65%, has massive implications regarding your chance of failure once added to the explicit advisor fee. To evidence how total costs impact your outcomes, we use the simplified example of a financial plan established over twenty years requiring a nominal rate of return of 7% on your invested capital. For the purpose of isolating the effect of fees, we assume that all advisors have the same investment skills and we show the probability of failure only as a function of the total cost incurred by the investor, hidden fees included.

The chart and the table below present the results.



All-in client fee for $1M account	Probability of financial plan failing
0.40%	0.22%
0.60%	0.73%
0.80%	2.02%
1.00%	4.72%
1.20%	9.49%
1.40%	16.77%
1.60%	26.46%
1.65% (industry median)	29.19%
1.80%	37.89%
2.00%	50.00%
2.20%	61.65%
2.40%	71.94%
2.60%	80.36%
2.80%	86.81%
3.00%	91.46%

Methodology

We assume that all advisors resort to the same traditional "60-40" portfolio, where 60% of the money is invested in the S&P 500 Index and 40% in 10-Year U.S. Treasury Bonds. Let us make clear that this is neither an investment recommendation nor an allocation rule that Lifeworks implements for its clients. It is simply a conventional assumption convenient enough to single out the impact of fees, as opposed to investment skills. In order to calculate probabilities, we assume that the returns of this 60-40 portfolio are normally distributed around an annual average of 9.14% with a volatility of 12.00%. This corresponds to the historical average and volatility of nominal returns on the 60-40 portfolio over the period ranging from 1928 to 2021, according to this dataset published by Aswath Damodaran.[2] Again, let us make clear that Lifeworks does not believe that returns are normally distributed and we do not construct our strategies based on this assumption. It is simply a conventional assumption about the distribution of returns that happens to be convenient enough for the purpose of singling out the effect of fees.

[2] https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html