Industry Content Series

The Case for Average Billing: Smoothing out market fluctuations.

Contents

Introduction

Welcome to the sixth in a series of industry content from Panoramix designed to help advisors succeed in a more challenging operating environment.

Particularly in these unprecedented, volatile and pandemic times, technology is playing an even bigger role in how advisors are interacting with their clients and managing their businesses.

In order to protect profits and smooth revenues as markets whipsaw up and down, many advisory firms are revisiting their billing methodologies to better synch up the timing of their revenues and expenses. As the industry has recently experienced, the dramatic revenue drops from the market break in early 2020, created tremendous pressure on RIA P&Ls. So much so, that over 2,000 firms turned to government subsidies in the form of PPP loans to provide a cash flow bridge to manage the revenue hit.

This revenue gap caused by the severe market drop (and subsequent rebound) served as a wakeup call for many firms, with a renewed focus on their billing methodologies. As a result, one key approach that is receiving increased focus is billing on an average basis.

In this installment of our *Industry Content Series*, recognized two years in a row as a Finalist in the wealthmanagement.com "Wealthies" Industry Awards, we examine billing on

Billing Methodologies

There are several ways for an advisor to bill, and we covered that in the second in our series "Billing Trends".

In summary, an advisor needs to decide on two things, whether to bill in advance or arrears, and how to determine the portfolio value for billing purposes.

Advance or Arrears

Typically, we see a bit more billing in advance than in arrears, but both are common. Again, refer to our previous white paper for a more in-depth view of the differences

Value Determination

There are 3 methods of determining the value of a portfolio:

- Portfolio Balance: the value of the portfolio on a given day, typically the end of the month.
- Average Balance: the average portfolio value during the billing period. There are a few ways to determine this
- Hybrid: a combination of balances and cash flows

The two most common we see are billing in advance on the ending balance and billing in arrears on an average balance.

an average basis, and we specifically look at how an average balance billing methodology can smooth out—or stabilize—your revenues in times of extreme volatility.

We believe that if you are billing in arrears and not doing some form of average balance, a case can be made that you may be billing incorrectly.

What Is Average Billing?

There are many ways RIAs bill clients (see sidebar "Billing Methodologies"), however, many industry experts believe that average billing can be considered as a "fair" way to bill in arrears. When billing in advance, you are estimating your billing basis based on today's values, because you can't see three months into the future. But when billing in arrears, you know what happened during the billing period and can adjust your billing basis accordingly. Quite often though, we see advisors trying so hard to do the "right thing" that they unnecessarily complicate their processes, which creates headaches and problems down the road. As one of the greatest philosophers of our time, Mike Tyson, said. "Everybody has a plan until they get punched in the mouth". In this case your audit is your punch in the mouth and as a result you start to question the complexity of your billing plan. Ultimately when it comes to billing there are many tradeoffs that exist between what is easiest to explain to an auditor, what is easiest to explain to your client, what is "best" for your firm, and more.

So, what is an average balance?

The simplest definition is the value at the beginning of the quarter plus the value at the end of the quarter divided by two. However, that approach doesn't truly reflect the effects of cash flows in and out of the account, so some argue that a simple mathematical average may not be in the best interest of the client. RIAs *can* compute a true average daily balance that will account for market fluctuations as they happen, as well as flows as they happen, but that daily approach is highly complex, difficult to track, manage and compute. Not only does it require a multi-page calculation sheet with 90-or-more numbers all added together and averaged in order to "show your work," it is often impossible to validate with your custodian. None of the major custodians have the ability to show historical daily balances in order to compute an average daily balance. Even if you have a system that stores those for you, and does produce a report to validate the number, it still isn't verifiable with the system of record, which is the custodian.

There are many other ways of computing an average balance that account for pro-rated flows, and which are verifiable with a custodian statement. Some are good, some are not so good. One common way that we have seen with some of our peers is to take the ending balance and subtract out the total flows for the quarter and then add them back in weighted on the time they were in the portfolio (the prorated flows). Panoramix supports this method, but it does not take into account the market fluctuation. Another method takes the ending balance plus the starting balance and subtracts out the total flows and divides by 2 to get a market average for the quarter, then adds back in the prorated flows. This accounts for both the market changes and the cash flows and is the primary average calculation that Panoramix uses.

In any case, an average balance is going to give you some middle ground between the high and the low for an account over the billing period, which many industry experts agree is an appropriate methodology when billing in arrears.

Q1 2020, a Case Study

As an example, In Q12020, the market dropped significantly due to the CoViD-19 pandemic. The S&P 500 dropped 20%, the Dow lost 23%, and the NASDAQ gave back 14%. Because most advisors bill on AUM, it is logical to assume that billing will be down a similar amount as well.

However, was that the case? Let's take a look at the data. One of the powerful benefits of the Panoramix system is our ability to aggregate data on thousands of accounts and derive key business intelligence that we are able to share with the industry to help inform best management practices.

2020 Billing Trends

	2020 Q1	2020 Q2
AUM	-11.40%	14.40%
All Billing	-10.50%	13.20%
Average Billing	-6%	5%

In Q1 2020:

AUM was down 11.4%

Once again asset allocation diversification has a direct impact on billing, as most RIAs manage an aggregate blend of equities and fixed income which does help out when the market is down. So, what about billing?

Billing across methodologies was down 10.5%

That tracks the AUM declines, and doesn't seem so bad in the big picture. With all the craziness in the market, advisors billing across methodologies in Q1 2020 was down about 10%. But what if we looked at only those billing on an average basis?

Billing on an average basis was down 6%

What does all of this mean? In a severe market downturn, billing on an average basis flattens out downturns and provides firms with more stable billing cycles.

What we are seeing is that in a market downturn, an average billing method isn't affected as much as an end balance method. We like to think of it as similar to a stock/bond split in a portfolio. Advisors are better covered for the bad times but don't do as well in the good times. But is that true? Let's look at Q2:

In Q2 2020:

AUM was up 14.4%

Billing across methodologies was up 13.2%

Billing on an average basis was up 5%

Based on our data, it does appear that an average billing methodology will bill less in an up market and more in a down market.

Pros and Cons

As demonstrated above, an average balance can provide RIAs with uniformity in billing and that can be a good thing. However, that is not the only consideration when determine your billing strategy. There are always tradeoffs, particularly for an average balance, and the following pros and cons apply.

Pros

- Flattens the peaks and valleys for more stability in budgeting. As seen in our example, compared to other methods, an average balance will bill more in a downturn and less in an upturn. If revenue volatility is concern for your firm, an average balance can help with that.
- Provides a “fair” way to evaluate the portfolio for the prior quarter. Simply taking the value at the end of a quarter and using that number to represent for the entire quarter is not the best thing to do. There could be flows into or out of the portfolio that would make the ending balance a less than ideal valuation method.
- Takes into account both market fluctuations and flows. For market fluctuations, consider a portfolio that goes from $100,000 to $120,000 during the quarter. What would be fair for billing purposes? The ending balance, $120,000, doesn’t seem fair, but the average of the two, $110,000 would be better. Similarly, if you had $200,000 at the start of the quarter, and you withdrew $100,000 a week before the end of the quarter and ended the quarter with $100,000, an average balance would prorate that flow and bill on roughly $195,000 rather than the ending balance of $100,000.

Cons

- Firms bill less when the market is up. As seen in our example, in Q2 of 2020 an average balance billing was up only 5% compared to an overall 13.2%. Since the market tends to be up more than it’s down, over time you will bill less with an average balance than with and ending balance method.
- Harder to explain and prove during an audit. If sailing through an audit is your primary goal in life, then an ending balance billing is far more appealing than an average balance billing. You only have to verify one number with the custodian. With an average balance, depending on how you calculate it you may not even be able to verify your numbers with statements, and that can lead to more work during an audit.

- Can be confusing to you your clients. Even though a client isn't an auditor, they may have the same questions as an auditor, namely "How did you arrive at that average balance?". Simplicity is usually best when it comes to billing, and an average balance isn't the most simple.

Conclusion

In these more volatile and uncertain times, We believe there is a case to be made for average billing. In fact, if you are billing in arrears, you ***should*** bill on an average balance. Every firm is different and there is no definitive default answer. However:

- an average balance is fair, which should make the regulators and auditors happy:
- it smooths out the peaks, which should make your finance people happy; and,
- if you chose a reasonable method of computing the average balance (like what Panoramix uses), it should make clients happy.

The key is to explain your approach clearly in your Form ADV if you are contemplating changing to an average billing approach. Most importantly, you should invest in automated, flexible and easy to use billing technology so that you have flexibility and operational efficiencies to respond to current market conditions, while strategically being able to better predict and drive revenues for your business.

ABOUT PANORAMIX

Panoramix™ was developed by Sapphire Software Services, a custom software and business-to-business automation company founded in 2003. Sapphire brings business applications to the web, provides consulting services with the best vendors and partnerships, and offers professional development capabilities to automate business processes. Sapphire specializes in business application software development for companies in the financial services sector. For more information on Panoramix, or to schedule a live demo of the product, contact Panoramix at support@panoramixfinancial.com. Also, go to panoramixfinancial.com to view an on-demand demo of Panoramix™.