THE INVESTMENT FUNDS INSTITUTE OF CANADA
L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA

Paying for Advice: Why Options are Important

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I. Introduction

Canadians have access to highly developed markets for investment products and services, and a broad array of channels and business models for investment services. This diverse marketplace includes a full array of options for the choice and payment of investment advice – options which have encouraged saving and added significantly to the collective wealth of Canadians over the years.

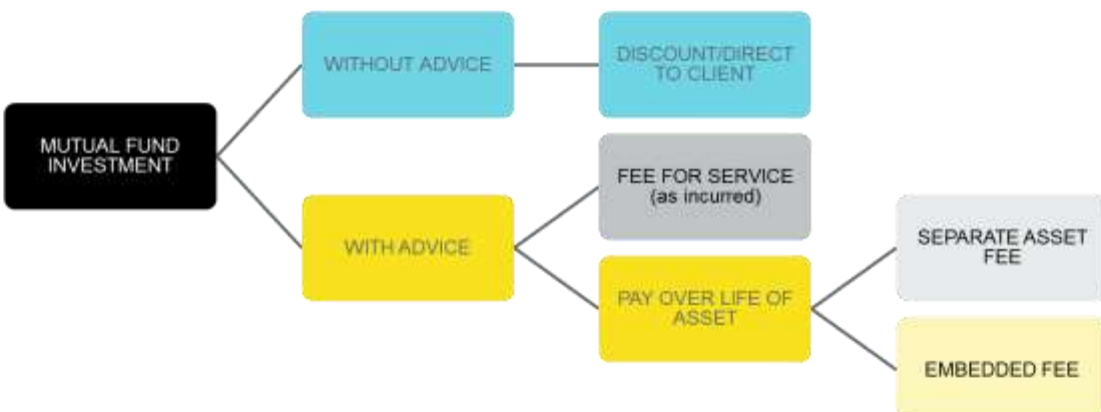
Canadian regulatory authorities have released a Consultation Paper[1] and are presently conducting research on mutual fund fees to understand what conflicts, if any, exist in payment models for advice. The results of this regulatory study may be important in helping regulators decide whether or not to limit or restrict the use of embedded fees, a popular form of paying over the life of the asset for upfront advisory services.

This paper provides an additional consideration for this regulatory debate - the consequences for small investors of limiting payment choices for advice.

II. Options in the Canadian Funds Market

Chart 1 below illustrates the options that exist in the Canadian market for purchasing mutual funds with and without advice.

Chart 1: Options in the Canadian Mutual Funds Market



[1] CSA Discussion Paper and Request for Comment 81-407 Mutual Fund Fees, December 2012

Investing Without Advice

While most mutual fund investors in Canada purchase their funds through an advisor[2], well-developed channels for the "do-it-yourself" investor also exist. Mutual funds can be purchased either through a discount broker or direct from the fund company.

The CIRANO (2012) research estimates that only 6% of Canadian investors meet the criteria required to be successful at being their own financial advisor.[3] So, while this can be a worthwhile option for financially literate investors, it is an ineffective option for the vast majority of investors. [4] Forcing Canadians to become do-it-yourself investors through choice restrictions when they are not equipped to do so, could carry a high cost in terms of their life time savings and financial wellbeing.

Investing With Advice

Almost nine-in-ten mutual fund investors invest with an advisor, and they benefit significantly from the disciplined savings behaviour that they acquire through these relationships.[5] There are good reasons for this. Through the Know-Your-Client process that a client undergoes at the initial stage of an advisory relationship, and through the development of a savings plan, and the monitoring and updating of that plan over time, the client gains a better understanding of his/her own objectives, risk tolerance and how best to achieve investment goals. The client becomes more financially literate and less prone to behavioural bias in their investment decisions. This is very conducive to wealth creation over time as evidenced in the CIRANO research.

There are two principal methods for paying the advisor and dealer: the "Fee-for-Service" model, where the investor pays for services as incurred; and the "Pay-Over-Life-of-Asset" model, where the investor pays over the holding period of the asset for a front-loaded stream of advisory services.

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[2] Pollara Research, "Canadian Investors' Perceptions of Mutual Funds and the Mutual Fund Industry 2013" reports that almost nine-in-ten investors (87%) go to advisors for purchasing mutual funds. See IFIC website: https://www.ific.ca/en/reports/

[3] These are described in the CIRANO report as investors who identify themselves as their own main source of investment information and capable of self-managing their investments and exhibit greater levels of education, income and financial literacy. Montmarquette *et al,* CIRANO (July 2012).

[4] Barber and Odean found that certain harmful behaviours affect the financial well-being of individual investors, including the tendency to sell winning investments but holding losing investments, and tending to hold undiversified stock portfolios. Barber, B. and T. Odean (September 2011). *The Behaviour of Individual Investors*, http://ssrn.com/abstract=1872211

[5] See Montmarquette, Claude and N. Viennot-Briot, "Econometric Models on the Value of Advice of a Financial Advisor", CIRANO, July 2012.

a. Fee for Service, or Pay as you Go:

In the Fee-for-Service or “pay-as-you-go” model, the payment of advisor fees is aligned with service delivery. For example, financial plans covering an individual’s needs across a broad range of financial products and services are generally only available on an up-front flat fee basis. The average flat fee for creating a financial plan in Canada is $1,400 (and $750 for updating an existing financial plan).[6] To charge less than this would place the advisor at risk, since there is no assurance that the client would continue with the relationship after the discounted service was received. For clients with growth prospects and $100,000 or more in assets, the financial plan may be included as part of the annual percentage of assets fee that is charged for account services.[7] These tend to be for higher net worth clients only.

Pricemetrix analysis demonstrates that smaller clients (defined as those with less than $250,000 in assets) have a negative effect on advisor revenues.[8] As a result, advisors are more likely to work with higher net worth clients in the Fee for Service option.

b. Paying Over the Life of the Asset:

The predominant means of paying for advice and dealer services in the Canadian market is through a fee based on an annual percentage of assets held. These payments can be structured as either *Separate Asset Fees* or *Embedded Fees*.

In Separate Asset Fee accounts, a rapidly growing segment of the market, the client pays the advisor’s dealer directly for advisory services.[9] The mutual funds held in these accounts are typically “F-class” funds whose MERs do not include fees for distribution.

In Embedded Fee accounts, dealer and advisor services are paid for out of the fund as a percentage of fund assets. The fee, sometimes known as a “trailer fee”, is disclosed as part of the fund’s management expense ratio (MER).

The Embedded Fee and Separate Asset Fee structures are equivalent in terms of cost to the client[10], and, with the advent of the recently introduced Client Relationship Model disclosure and reporting rules, will be similar in terms of disclosure obligations of the distributor once these approaches come into place in 2016.[11] These new disclosures will provide significant improvements in clarity and transparency in the market and will ensure the availability of information whichever option is chosen.

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[6] *Your practice and profitability,* AIM Trimark, Based on research by Advisor Impact Inc, Special Supplement to Investment Executive, September 2004.

[7] Research from PriceMetrix has found that the average fees range from 0.93% (for account sizes of $1 million or more) to 1.90% (for account sizes lower than $100,000). PriceMetrix Inc. survey of average fees drawn from 10 larger and medium-sized advisory firms in Canada, December 31, 2011.

[8] *Moneyball for Advisors*, Pricemetrix Insights, Volume 7, October 2012.

[9] F-Series are available in 2057 funds from 78 fund companies with a total AUM of $42.8 billion. Though currently only 4% of total fund AUM, F-Series funds are growing rapidly and accelerating – with a cumulative annual growth rate over the last 3 years of 23.5% and 35.1% over the last year. Investor Economics, *Insight Monthly Update*, June 2014.

[10] In the U.S., where Separate Asset Fees predominate, Strategic Insight has reported that “one theme of concern is the higher-than-average asset velocity within fee-for-advice account structures. This more frequent activity at times may be reducing potential investment gains for some investors”. *A Perspective on the Evolution in Structure, Investor Demand, Distribution, Pricing, and Shareholders’ Total Costs in the U.S. Mutual Fund Industry,* Strategic Insight, November 2012.

[11] The embedded fee structure, however, has the advantage of simplicity over its counterpart in that it provides in the MER an all-in cost of ownership to the investor, whereas the separate asset fee structure requires a more complex process for the calculation of all-in costs to the investor.

III. Paying 'Over the Life of the Asset' – the Business Case

It is useful to understand the business case for spreading payments for investment advice over the life of the investment.

Front-loaded stream of services

In accepting a new client, an advisor agrees to provide a front-loaded stream of services. Significant initial time is required in getting to know the client and developing and implementing a financial or investment plan tailored to the client's needs. The services would typically include: meeting the client usually more than once, developing an investment strategy; structuring the proper accounts (i.e. RRSPs, TFSAs, non-registered investments), making investment recommendations and implementing the plan, periodic consolidated reporting and ongoing portfolio management and rebalancing.

The nature of this work flow is front-ended in the first year of the relationship when the account is opened and plan established and initiated, and is subject to periodic review and adjustment at key life cycle events and ongoing services related to account monitoring, periodic client reviews and administration.

Compensation for advice and dealer services

With most mutual funds, the front-loaded stream of advisory services is paid for uniformly over the life of the asset through payment of a dealer/advisor fee, a portion of which goes to the advisor. With Embedded Fees, the dealer/advisor fee is paid out of the fund as a percentage of the asset as part of the fund's management expense ratio (MER). On average, 0.78% of the assets invested in a long-term fund are paid annually by the fund to the dealer[12], of which approximately two-thirds may go to the advisor for advisory services and the rest kept by the dealer to pay for administrative, compliance and regulatory oversight functions.

Many clients have very limited assets when they first begin working with an advisor. Chart 2 below provides data from the last three annual investor surveys conducted by Pollara Research. The surveys have consistently shown that nearly 40%.of all clients with advisors had $10,000 or less to invest when they commenced their relationship with an advisor and more than 70% had less than $50,000.[13] For an entry level mutual fund investor with $10,000 to invest, the average trailer fee paid to an advisor would result in an initial year's payment of only $52,[14] a small payment for services provided in the first year.

Despite the initial low balance, the advisor may still accept the client. Business is done because the payment model promises a continuing income stream which will grow with the asset level. The client benefits from the commitment of the advisor who will encourage him/her over the life of their relationship to continue to save. What we have is an alignment of interests – both the client and the advisor benefit from the growth of the portfolio.

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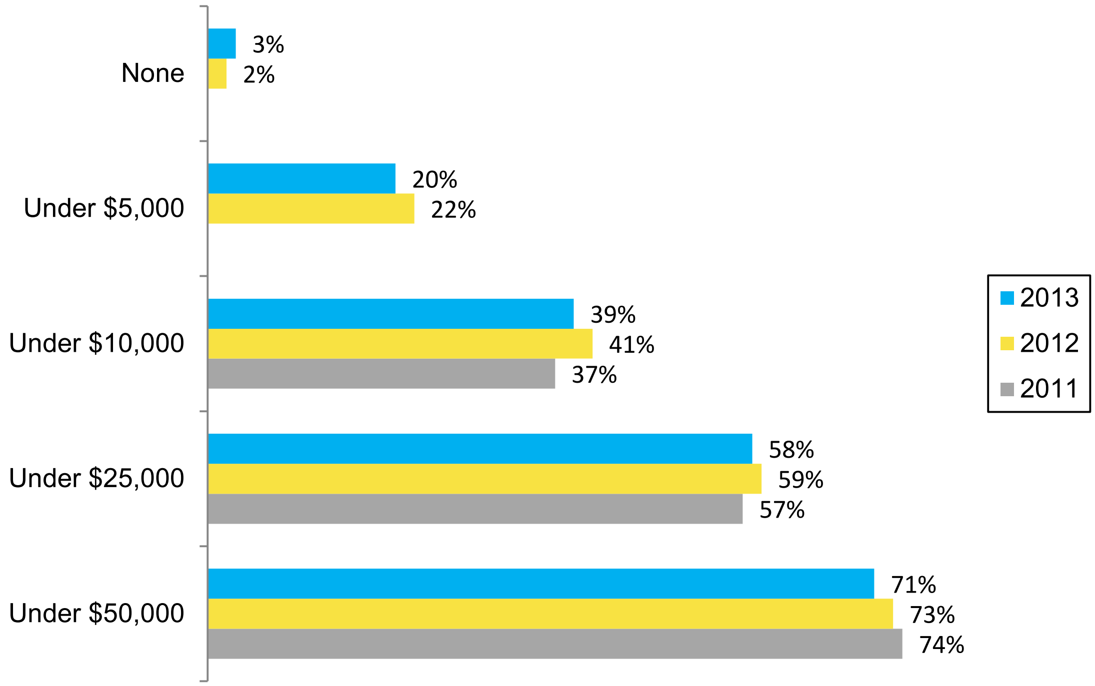
[12] *Mutual Fund MERs and Cost to Customer in Canada*, Investor Economics, 2012.

[13] Pollara Research, "Canadian Investors' Perceptions of Mutual Funds and the Mutual Fund Industry 2013" See IFIC website: https://www.ific.ca/en/reports/

[14] If the investor contributes an additional $50/month towards the account, this would amount to an additional $5 advisory fee ($3 to the advisor and $2 to the dealer) over the period of one year. The total fee collected by the advisor over the first year of the relationship would be $55

Chart 2: Value of Savings/Investment When First Started Using an Advisor[15]



IV. Paying 'Over the Life of the Asset' - Alignment of Long-term Interests

When an advisor is paid a fee based on a percentage of assets held in a client's account, whether the fee is embedded in the product price or paid separately, there is a long-term alignment of interests for the advisor and the client in growing the account. The advisor is interested in seeing his/her client do well as it will result in a growing income stream. There is a built-in incentive in such a relationship for the advisor to provide the best ongoing service possible that will lead to asset growth. In a pay-as-you-go relationship, on the other hand, there may be less commitment to ongoing service and less incentive for the advisor to achieve asset growth for the client.

[15] Pollara Research (2013), Respondents were asked "When you first started using a financial advisor, which of the following categories best represents the total value of your household's savings and investments at that time, excluding your primary residence?"

V. Paying 'Over the Life of the Asset' - An Important Option for the Smaller Investor

As noted above, individuals just beginning to invest have limited assets.[16] The Fee-for-Service option is generally not available to individuals with these small amounts to invest. The cost would be prohibitive. A flat fee of $1400 for a financial plan, for example, would amount to 14% of an initial $10,000 investment. This would cause most entry-level investors to avoid advice entirely. It would take almost three years of $50 monthly contributions to make up the $1,400 fee-for-service cost.

Paying-as-you-go may also not produce as favourable savings outcomes as paying-over-the- life. An investor with $10,000 to invest who must pay $1400 to engage an advisor has an initial investment of only $8600. Contrast this with a pay-over-the-life fee structure where the full $10,000 is invested and allowed to compound over the life of the investment.

In a world with more limited options for spreading the up-front payment for advice over the life of the asset, an entry level investor would be less able to engage an advisor. International examples bear this out.

In the U.K., where payment options have been limited by regulation, the evidence is beginning to show a reduction in the availability of advice, particularly for lower balance investors[17].

In the U.S. where compensation has moved by market forces to principally an unbundled structure, investors are paying more for advice[18].

The unintended consequences of more limited payment options are: fewer investors, particularly those with limited assets, developing a relationship with, and having the ongoing support from, a financial advisor, and fewer developing the beneficial savings behaviours acquired through those relationships.

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[16] As further evidence, the average account size at MFDA registered dealers is $36,000 and at IIROC registered dealers $67,000. Investor Economics, 2013.

[17] *Up to 20m people consigned to advisory limbo,* Dave Baxter, FT Adviser, July 30, 2014.

[18] Strategic Insight reports that "With unbundled fees-for-advice typically rising as investor account sizes decrease (due to the lack of economies of scale in servicing such smaller accounts), many middle income mutual fund investors are faced with the reality of significantly higher ongoing costs for financial advice – or even the complete lack of an advice option – within the continued transition to a fee-for-advice culture in the U.S" *.A Perspective on the Evolution in Structure, Investor Demand, Distribution, Pricing, and Shareholders' Total Costs in the U.S. Mutual Fund Industry,* Strategic Insight, November 2012.

VI. Continued Involvement with an Advisor Yields Greater Savings Over Time

In the seminal book *Nudge* on behavioural economics, the authors make the case that standard theories about saving for retirement are based on two incorrect assumptions – that investors are able to calculate how much they need to save for retirement, and that they have enough willpower to implement the required plan to get there. In fact, say the authors, neither is generally true.[19] Being able to address these common behavioural deficiencies towards saving may be one of the most beneficial aspects of working with an advisor.

Individuals with limited assets are more likely to engage an advisor and benefit from advisory services if they are able to spread advice payments over the life of the asset, than if they are required to pay the full economic value of advisory services upfront. If options for spreading out payments were more limited, many of these individuals would not engage an advisor, and would not benefit from the substantial long-term wealth accumulation that is possible in advisory relationships, as documented in the CIRANO (2012) study.[20]

VII. Conclusion

In discussions on the appropriateness of the embedded fee model as a means of paying for investment advice, the focus has been almost entirely on the extent of conflicts posed by this model and the effectiveness of disclosure.

An additional consideration, largely absent from the debate, is the important role these structures have for small investors to encourage saving. Canadians of limited means, and those just beginning to save, need effective access to advisors and savings vehicles to help to secure their financial futures.

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[19] *Nudge*, Richard H. Thaler and Cass R. Sunstein, Penguin Books, 2009, p. 106.

[20] After factoring out the impact of 50 socio-economic, demographic and attitudinal variables that also affect individual financial assets CIRANO shows that advised households that have worked with a financial advisor for four to six years accumulate 58% (1.58 times) more assets than identical non-advised households, and those that have worked with an advisor for 15 or more years accumulate 2.73 times more. CIRANO, July 2012.

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