THE PROBLEMS with investment advice

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The Future of Financial Advice reforms were designed to improve the quality of financial and investment advice offered to the public. In particular, they sought to correct conflicted remuneration structures which led advisers to act in their own interests rather than those of their clients. However, the reforms did not confront some important problems in the industry — its fragmentation, horizontal integration and the need for improved education of advisers and investors.

Recently there has been considerable discussion about a package of reforms to investment advice. Future of Financial Advice or (FoFA) which is being implemented following widespread dissatisfaction with the performance of the industry. This paper considers whether the reforms are adequate to deal with the causes of this dissatisfaction. First, the paper identifies the desirable characteristics of investment advising. It then outlines the FoFA reforms and it considers any further reforms that appear to be necessary.

This paper is limited to the financial advice given to individual clients and does not venture into the area of advice given to businesses. Of course, individuals vary in many respects, such as their income, wealth, age, marital status, number and age of children, and objectives.

While the paper may appear to reflect negatively on the investment advice industry, it is important to recognise that the industry provides a vital service to investors. This is particularly relevant in Australia where many investors run self-managed superannuation funds (SMSFs) as an important component of their retirement savings. Proprietors of such funds bear the investment risk they create. Also, defined benefit funds are becoming increasingly uncommon and contributors to industry or public superannuation funds also bear investment risk.

The problem with this situation is that many investors make poor decisions which reduce their retirement income. These poor decisions arise from:

- Considerable evidence that investors are irrational in making investment choices — they are ‘loss averse’, they resist realising losses and they are distracted by irrelevant characteristics of investment products.

Recognition of the third characteristic led to the emergence of behavioural finance theory (see Bloomfield 2008; Valentine et al. 2011, pp. 251-2).

A desirable approach to investment advice

The time horizon and investment objectives

Investment advice should be tailored to the client’s situation. This means that a ‘one-size-fits-all’ approach is unlikely to be the correct approach. It is unlikely that there are any two individuals who have exactly the same characteristics in the areas mentioned in the previous section of the paper. Also, people have different objectives and preferences with respect to their investment choices. For example, they have different target retirement dates, different expectations for the level of their retirement income and different levels of wealth that they wish to pass onto their families. Advice should take account of these differences; that is, it should be tailored to each individual.

In addition, people often have subsets of their investment portfolios that are intended to be held for different purposes. The major objective of saving is to provide for retirement, but people also save for shorter-term targets such as a holiday, a deposit for buying a house or a car. Investors will also want to hold funds to meet unexpected emergency needs. The funds held for each of these aims should be treated differently. For example, funds accumulated for short-term objectives should be invested in more liquid assets than funds intended for the provision of retirement income.
This discussion raises an important general point — the appropriate choice of assets for an investor depends on the time horizon of that investor. Consequently, an investment adviser should attempt to establish the appropriate time horizon for the separate elements of a client’s portfolio by an objective analysis of the appropriate strategy for the client in conjunction with discussion with the client. Bateman and Kingston (2012) quote results from a simulation done by Viceira (2001) which illustrates this point very clearly.

**Risk profiling**

It is often asserted that advisers should adjust their advice to fit their clients’ risk profile. That is, a client who is unable to bear risk should not be put into investments which yield a high average return, but highly variable short-term returns. An extreme case is where the client is ‘loss averse’. That is, they are uncomfortable with an investment which produces a negative return in any period. It appears that many investors do suffer from loss aversion (see Valentine 2012). The accepted industry tool for measuring risk attitudes is the risk-profiling questionnaire.

However, it appears that this approach adds very little value to the advisory approach. The arguments in support of this view are as follows:

- It is not clear that a ‘risk profile’ exists for most investors. For example, loss aversion is a singularity in any such profile. It implies that an investor will prefer an asset which has a low average return to any other asset with a much higher average return which produces an occasional negative return.

- It is not clear that investors understand their own attitudes to risk. All advisers have encountered situations where investors present themselves as willing to bear risk in order to obtain a higher return but who reveal themselves as loss averse in a falling market.

- Most risk questionnaires are short term (that is, they offer respondents choices for one year), whereas the most significant investment decisions cover many decades.

**A desirable approach**

In view of these problems, it would be desirable if the advisory process took the following form:

- Initially the adviser should establish the important characteristics of the client such as age, income, net worth and investment objectives, and important subsets of investments.

- The adviser should discuss investment alternatives with the client to obtain information on their basic attitudes to investment and borrowing.

- The adviser should then provide suggestions for each of the pockets of assets identified for the client. Each of these suggestions should be explained and information on the historical volatility of returns over the relevant time horizon provided. The client should be required to acknowledge that they have received this advice.

**Education of investors**

An important element of this process is to educate investors about what they should do in their long-term best interests. For example, a client who is not close to retirement or loss averse, but who is contributing to a self-managed superannuation fund should be advised to adopt a portfolio of assets which yields high average returns over long periods even though these assets suffer an occasional year of negative returns. Shares and property are the obvious candidates.

ASIC could improve the quality of investment advice by improving the informational content of Product Disclosure Statements (PDSs). Gallery et al. (2013) discuss some proposals in this regard. They also report the results of a survey which indicates that advisers do not have a high opinion of the usefulness of PDSs. They doubt that clients use them in making investment decisions and that advisers make extensive use of them. However, Gallery et al. (2013) doubt that shortened PDSs will reduce the problems. Also, the FoFA requirement that advisers justify their recommendations is subject to similar problems. Clients will often not understand or be able to evaluate these justifications.

It would also be desirable if Australian managed funds were required to report regularly on measures of the risk inherent in their portfolios. There appears to be a low level of interest in such measures in Australia as compared to, for example, the United States. Two risk-based measures that could be used are the Sharpe index and Jensen’s alpha (see Valentine and Scott 2012, pp. 166–9).

Investment advisers are often criticised for recommending tax-effective products. It is argued that in considering these products insufficient attention is given to their basic soundness. There are certainly examples that provide support for these views. A return to the artificial products of earlier times is certainly not recommended, although it may be desirable to consider special arrangements to encourage entrepreneurial projects. Nevertheless, as part of meeting a client’s needs, an adviser must ensure that he/she does not pay any more tax than necessary.

**The FoFA reforms**

Bateman and Kingston (2012) provide a comprehensive summary of the FoFA reforms. While most of the FoFA reforms were introduced on 1 July 2013, there are still some issues to be
resolved, for example, restricted licences, tax agents, grandfathering and vertical integration. A last-minute addition to the reforms was that the descriptions 'financial planner' or 'financial adviser' can only be used by those who are appropriately licensed.

A major component of the reforms is the introduction of a statutory fiduciary duty for advisers to act in the best interests of their clients rather than in their own interests. This makes formal a requirement that has been assumed to hold for many years but may have been unenforceable in the absence of this formal requirement. Advisers must make 'reasonable inquiries' of their clients to ensure that they understand their position within reasonable constraints.

A large part of this commitment is the banning of remuneration structures which create conflicts of interest, that is, incentives to ignore the client’s interests in making recommendations (see ASIC Regulatory Guide 246). FoFA prohibits:

- incentive payments from providers based on the volume of business written;
- 'soft-dollar payments' (for example, conference support over $300);
- asset fees on geared investments and trailing commissions.

However, trailing commissions and incentive payments for business written already in existence have been grandfathered, that is, they can continue into the future.

The way in which investment advisers have been remunerated has the possibility of creating conflicts of interest. Prior to the recent reforms, a system of commissions was in place and this had a number of counterproductive impacts. First, it encouraged advisers to recommend some very risky investments which paid a high commission simply because they were risky.

Second, the opportunity of increasing commissions (paid on funds under management or FUM) induced some advisers to over-gear their clients’ investments. This magnifies any losses incurred and increases the probability that investors will be forced to liquidate their positions at a time when a large loss has been recorded. That is, they do not have the alternative of trading out of their difficulties. The move to higher leverage became more pronounced in the run-up to the global financial crisis.

Third, advisers did not direct clients’ attention to attractive alternatives because this did not generate commissions for the advisers. For example, given the tax advantages provided to home ownership in Australia, the purchase of a home is a good way to provide for retirement. Also, paying off mortgages as rapidly as possible is a good way of using any free funds that become available because the return earned (the interest saved) is tax free.

Retail clients must be given an annual disclosure of fees paid and receive an opt-in (renewal) opportunity every two years (see ASIC Regulatory Guide 245). Such clients must receive, every year, a fee disclosure statement (FDS) which provides a summary of the fees to be paid by the client and the services that the client will receive. Fines can be assessed against individuals or firms not satisfying this requirement.

A ‘retail client’ is most simply defined as one who is not a wholesale client. The latter category includes business owners, professional investors etc., but also includes an individual who has earned $250,000 p.a. (gross) in the past two years or has net assets larger than $2.5 million. This requires a certificate from an accountant. The rationale for this exemption is unclear. A person can hold a responsible and well-paid position without possessing any financial sophistication. Many of them are excessively focused on tax minimisation.

Advisers must also justify their recommendations, demonstrating that these are in the interests of the client. Advisers are still required to provide a Financial Services Guide (FSG) when personal advice is offered. Personal advice is given when the adviser has considered at least one of the objectives, financial position or needs of the client, or might reasonably have been expected to do so. Also, a Statement of Advice (SOA) must be provided when recommendations are made. As a result, it appears that the FoFA reforms have added to the complexity and volume of paperwork surrounding the provision of investment advice. This could act as an incentive for clients not to access the available information and it imposes higher compliance costs on the adviser.

The FoFA model will cause a shift towards upfront fees, although asset fees can still be charged so long as the assets do not result from gearing. Also, it appears that ‘success fees’ can still be charged, that is, fees based on the return earned on the recommended portfolio. If so, this could create an incentive to recommend over-gear or otherwise risky portfolios which could yield very high returns. An upfront fee could have the unintended consequence of deterring many investors from seeking professional advice although they are seriously in need of it.

Insurance will continue to be sold on a commission basis (including trailing commissions) although disclosure must be made of these commissions. This could be a problem — Valentine and Scott (2012, pp. 17-19) argue that the generous commissions available on insurance may induce advisers to recommend that clients over-insure themselves.
However, the new rules require advisers to justify their recommendations.

Leverage (at a moderate level) is likely to be appropriate for investors with a long time horizon. Therefore, the FoFA control which forbids the payment of commissions on leveraged assets creates some difficulty in this area. It may be better to consider subjecting lending to a maximum leverage ratio as a way of controlling excessive gearing. However, advisers should ensure that the portfolio is diversified and it should not involve a very high degree of leverage. If these conditions are not met, there is always a non-zero probability of a catastrophic loss occurring at some point over the life of the portfolio.

Remaining problems

Horizontal integration

A major conflict of interest in the industry is the fact that product providers (for example, banks and insurance companies) own investment advisory services. This means that the organisation can receive both a margin on the product and a commission from individual clients. It is likely that such services will recommend the products of their parents. That is, they are actually distribution networks rather than advisory companies. The advisers are largely marketers, but this allows their parents to adopt a form of remuneration that avoids significant reliance on commissions, which gives them a competitive advantage over independent and independently owned firms. It appears that opportunities for obtaining truly independent advice are diminishing.

Many larger advisory firms are considering the adoption of the vertically integrated model, that is, creating platforms. The competitive advantage is enhanced by the decision to allow platform holders to pay an extra 0.2 per cent of assets on the platform to licensees.

Fragmentation of the industry

Another problem is that organisations that provide what is essentially investment advice are not part of the same regulatory regime as investment advisers. Such organisations include real estate agents, insurance brokers, mortgage brokers and dealers in such assets as art, antiques, coins and stamps. It is generally believed that investment advice should be based on an overall view of the client’s portfolio rather than be directed towards individual assets. Also, if some parts of the investment advice industry are heavily regulated and other parts are lightly regulated, business is likely to shift into the lightly regulated area.

Buying a house is the most important investment that most households make. However, advice on choosing real estate (from a real estate agent) or financing it (from a mortgage broker) is not included in financial advice. It would be desirable for these activities to be integrated with other forms of investment advice. For example, it is unlikely that real estate agents mention the role of diversification to investors. The relatively new ability of SMSFs to purchase property (doing so through a bare trust owned by the fund) has created some pressures for mortgage brokers to learn something about these funds. Recently, ASIC expressed some concern about real estate agents giving advice on the purchase of properties by SMSFs.

Educational requirements

There is also the question of advisers’ required level of educational qualifications. This matter is currently under discussion. There was a proposal for advisers to undergo an annual exam, but this idea has been put on hold by ASIC until the regime change occurred. Such a test is likely to be based on the details of financial advice. However, there seems little reason why less should be required of investment advisers than, say, accountants. Advisers’ education should include a solid academic grounding in the theory of investment and asset markets.

A framework for advice was discussed earlier. It was based on the premise that advice should be tailored to the individual needs of each client. In addition, it should be supplemented by:

> An advertising campaign to establish the usefulness of receiving investment advice on the basis of an upfront fee.

> Giving each client a simple ASIC-approved booklet setting out the basics of investment including a discussion of diversification, the time horizon of investments and leverage.

The booklet should also discuss the impact of largely unpredictable life events on the investment portfolio and how these possibilities could be taken into account. These include loss of job, major health problems in the family, marital breakdown, death and the resulting estate management process. Many investors may be unaware of these dangers or be in denial of them.

Also, the booklet should explain the concept of informational efficiency as it applies to share markets. The investors’ attention should be directed to the alternative of investing through indexed funds which are often found to give better results than actively managed funds (see, for example, Drew, Stanford and Taranenko 2001).
Conclusion
The FoFA reforms are a step in the right direction. However, they have not addressed some important fundamental problems — the fragmentation of investment advice, horizontal integration (that is, links between product providers and the advisory function), the educational requirements for advisers and attempts to educate the public on investment. And, in the short term, FoFA should be adjusted to limit (rather than discourage) leverage, and the distinction between retail and wholesale clients should be eliminated.

References


