Transparency, Informed Consent and our Clients' Best Interests

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STANDUP for Professionalism

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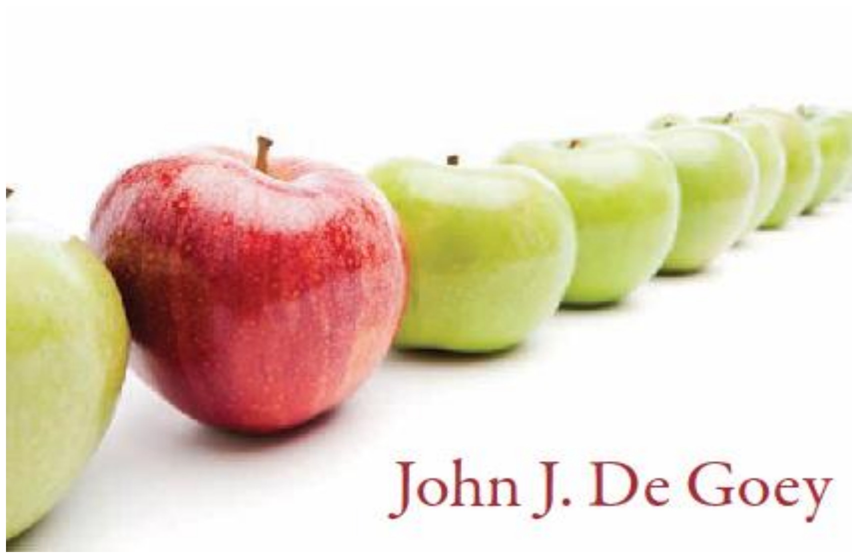
STANDUP

- Scientific
- Testing
- And
- Necessary
- Disclosure
- Underpin
- Professionalism

The Professional Financial Advisor III

PUTTING TRANSPARENCY AND INTEGRITY FIRST



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Areas of Discussion

- What do clients know about how we get paid?
- To what extent can (should?) CFP professionals assist clients in understanding such things?
- Possible ‘Best Practice’ suggestions
- Possible ‘Best Interest’ implications

Clients think advisors have to work in their ‘best interests’

- I’ve never met anyone who is upset about a circumstance that they’re oblivious to.
- Is this a case of ‘what you don’t know won’t hurt you’? What does the evidence say?
- How many of you, in abiding by the CIFPs’ Practice Standards and the FPSC’s Code of Conduct are already putting client interests first?

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If a Best Interests Standard was Adopted Today…

- Would you be able to defend your conduct?
- Would you be able to defend product recommendations?
- How would you do so regarding research?
- What reasoning would you point to?

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Code of Conduct: Objectivity

- Members of the CIFPs are expected to be objective in providing products and services to their clients. Members shall recommend the best suited products and services based on the need of the client.

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CoC: Professionalism

- Members of the CIFPs shall show diligence, respect, honesty and sound judgment in their work. They must remain objective and impartial, while doing their work thoroughly.
- Members must make recommendations based on empirical evidence to the greatest extent possible, bearing in mind the balance of probabilities (both in regard to frequency and degree) associated with variable outcomes.

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Do you encourage clients to buy lottery tickets?

- “Can’t win if you don’t play.”
- Question of risk and reward (like many other investment options), only more so.
- Possible main difference is in regard to both frequency and degree…
- Very small (0.0001%?) chance of winning, but may be life-altering if you do win.

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Informed Consent

- Step 4 of the six-step process involves making written alternative recommendations.

- Using lottery tickets as an everyday example, to what extent do investors/ clients intuitively understand the risks and rewards (i.e. possible outcomes) of the recommendations you make?

- What are your obligations (and possible liabilities) if you disagree with their final assessment?
  Is evidence relevant?

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Suitability

- The current test is simply that product recommendations be suitable for clients and their circumstances.

- Advisors are not clairvoyant. The best solution cannot be reliably identified in advance and can only be determined with certainty after the fact.

So, is it right for clients?

- A recommended investment may or may not work out, but the pros and cons associated with any product or strategy ought to be a material pre-purchase consideration.

- Is ‘good enough’ really good enough?

- In certain circumstances, clients might become ‘risk seeking’. What about a couple of games of red/ black?

One STANDUP Opinion…

- Disclose the options, benefits and risks in writing
- Be sure the client understands both the pros and the cons of all major options (for both products and business models)
- Determine if there's a suitability 'fit'
- Let the client decide

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Comparing Commissions and Fees

- Commissions are only half deductible- and only against realized capital gains.
- Hourly fees (e.g. financial planning) are not deductible
- Investment counseling fees referenced in: ITA sec. 20 (1) (bb) are deductible at top marginal rate –under certain circumstances.
- Is it even possible to be a fiduciary using a commission based business model?

Advisory Fee Deductibility

- Most (~68%) of advisors work primarily on commission*
- A few planners charge by the hour
- A few use a salary plus bonus structure
- A few charge an asset-based fee based on total household assets (may be scalable)
- Only the latter is (potentially) tax deductible

*Environics Advisor Perception Study, November, 2012

Meanwhile, most advisors are moving to trailers

- In 1996, trailing commissions accounted for slightly more than one quarter of the advisor’s book of business. In 2011, their share was up to 64%. Also, by the end of 2011, only 2.6% of Canadian mutual fund assets were in F Class format.

- Source: Investor Economics, Monthly Update, March 2012, pp. 9-12

Fee-Based Scalability

- IMHO, it does not take 4 times the work to manage a $1,000,000 account than it does a $250,000 account. Fees could reflect that inherent scalability.

- For example, I charge 1.4% on the first $250,000 and 0.6% on all additional household assets- and $20 a trade.

Planning as a loss leader

- Planning fees, as mentioned earlier, are not tax deductible.
- Some advisors “give away” their planning as “part of the offering” rather than charging separate, non-deductible fees.
- ‘Best Interests’ might/ might not apply irrespective of any planning work.

Why should I care?

- This is a big potential “win” for clients.
- A $10,000 fee, if fully deductible, can generate a refund of up to $4,640 (using Ontario's MTRs).
- Transparency ought to be “worth something.”
- Most investors don’t know either how or how much they’re paying. I suspect they would have a preference for lower costs if a lower cost option was offered.
- Do you offer low cost products?

There’s a lot that’s Communicated Through Inference

The great enemy of the truth is not the lie - deliberate, contrived and dishonest - but the myth - persistent, persuasive and unrealistic.

-John Fitzgerald Kennedy

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A Quick Observation about Truth…

- ‘Hiding the truth’ and ‘allowing myths to persist’ are, to me at least, effectively synonymous. Truth… whole truth… nothing but the truth- that’s what clients want (and expect).

- Truth is different from opinion, because everyone has a right to an opinion. The challenge comes from the acceptance (or not) of evidence. Darwin, Galileo and dozens of others had a hard time speaking truth.

- Evidence and disclosure go hand in hand (e.g. cigarettes) once truth has been established.

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Other Potential Disclaimers and Disclosures:

- Mutual Funds are not Free. Their cost (MER) is applied against your returns. Returns are reported with MERs deducted.
- Most actively managed funds lag their benchmark over long timeframes and it is debatable if those that do outperform can be reliably identified in advance.
- Many mutual funds charge trailing commissions for advice even if they are purchased through a discount broker where no advice is given.
- Cost can be a major determinant of performance. Research shows that expensive funds usually underperform cheap funds, on average.

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Embedded Compensation Can Lead to Bias

It is difficult to get a man to understand something when his salary depends on his not understanding it.

- Upton Sinclair

To be clear, I'm not necessarily opposed to embedded compensation…
I'm just saying that it causes bias

Be Honest with Your Clients

- Many advisors say they prefer active management offered by mutual funds. Sorry, but I don't believe they're telling the whole story. Most of them have virtually no assets with relatively better-performing actively-managed fund companies like Steadyhand, Saxon, Chou, Beutel Goodman, Phillips, Hager and North, etc. No trailer = no shelf space, it seems.

- In my view, their embedded compensation business model drives their product recommendations far more than any other product consideration or due to active management as a value proposition. People are entitled to use whatever products they want- but their clients are entitled to know why the recommendation is being made, too.

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For Example…

- Embedded Compensation: Some call them ‘trailing commissions’; others call them ‘trailer fees’… obviously, they cannot be both.
- CRA, CSA and all advertisements refer to trailers as commissions- so why the difference in nomenclature?
- Calling an apple an orange doesn’t make it an orange. I think it has to do with positioning. Definitions of commissions and fees are distinctly different.

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Professional or Salesperson?

- Rightly or wrongly, for better or worse, society has ‘top of the mind’ opinions of people. Doctors, accountants and lawyers are in one category and commissioned salespeople are in another…
- Trailers = commissions = a sales rep
- Fees = how pros get paid = a professional

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Positioning, Branding and Value Propositions

- Determine Products
- Determine Fees
- Determine Value proposition
- Many advisors use fund picking and/ or stock picking as part of their ‘value add’… There seems to be a clear need to disabuse clients of misconceptions that might exist

Both a Business Model and a Value Proposition

- Advisors are free to use whatever products they want: individual securities, segregated funds, mutual funds and/ or exchange-traded funds. They can ‘mix and match’.

- Advisors should have clear, compelling reasons for the recommended product before going to their clients.

- Communicate those reasons to clients before making the buy.

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My Product Bias(es)

- Cost-Effective
- Pure (and fully invested)
- Broadly-diversified
- Tax-effective

Commission Based

- Pros:

  Clients understand it (sort of) and aren't complaining… no awkward "I've got to get paid" conversations.

- Cons:

  Embedded compensation lacks transparency and is based on sales; not advice. Usually features higher cost.

Fee Based

- Pros:

  Alignment of interests, cost and tax reductions, deductibility, ‘directability’, scalability, wider product shelf, professional positioning.

- Con:

  Change is hard- and there is always a risk of ‘milking’.

The ABCs of Investing

- A is for “Alpha” – the amount of ‘out performance’ that is attributable to security selection, market timing, etc.
- B is for “Beta” – the risk and return level of the market in general
- C is for “Costs” – all investment products have them and they impact performance numbers. In aggregate, all investing is zero-sum before costs; negative sum after costs.

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Cost Matters!

- Grandma said: “a penny saved is a penny earned”

- John Bogle says: “you get what you don’t pay for”

For more on the negative performance correlation and overall impact of costs, see: “The Unequivocal Mr. Bogle” “Price of a Portfolio” and “Price Chopper” as links in my web site: www.johndegoey.com

What are the components of client cost?

- There are three main elements: trading costs (including taxes and bid/ask spreads), product costs and advisory costs.
- Steps should be taken to control and minimize all three.

What do Passive Products* usually cost?

- On average, about 0.50%
- Some cost as little as under 0.10%; others as much as 0.95%

* Passive products generally do not provide embedded compensation. Actively managed products (also without compensation) generally cost about 1% more.

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What's the Difference?

- This format can typically save clients a fair bit in overall costs- perhaps 60 to 120 bps.

- On a $500,000 portfolio, that's $3,000 to $6,000 ANNUALLY…. possibly over $200,000 in a lifetime.

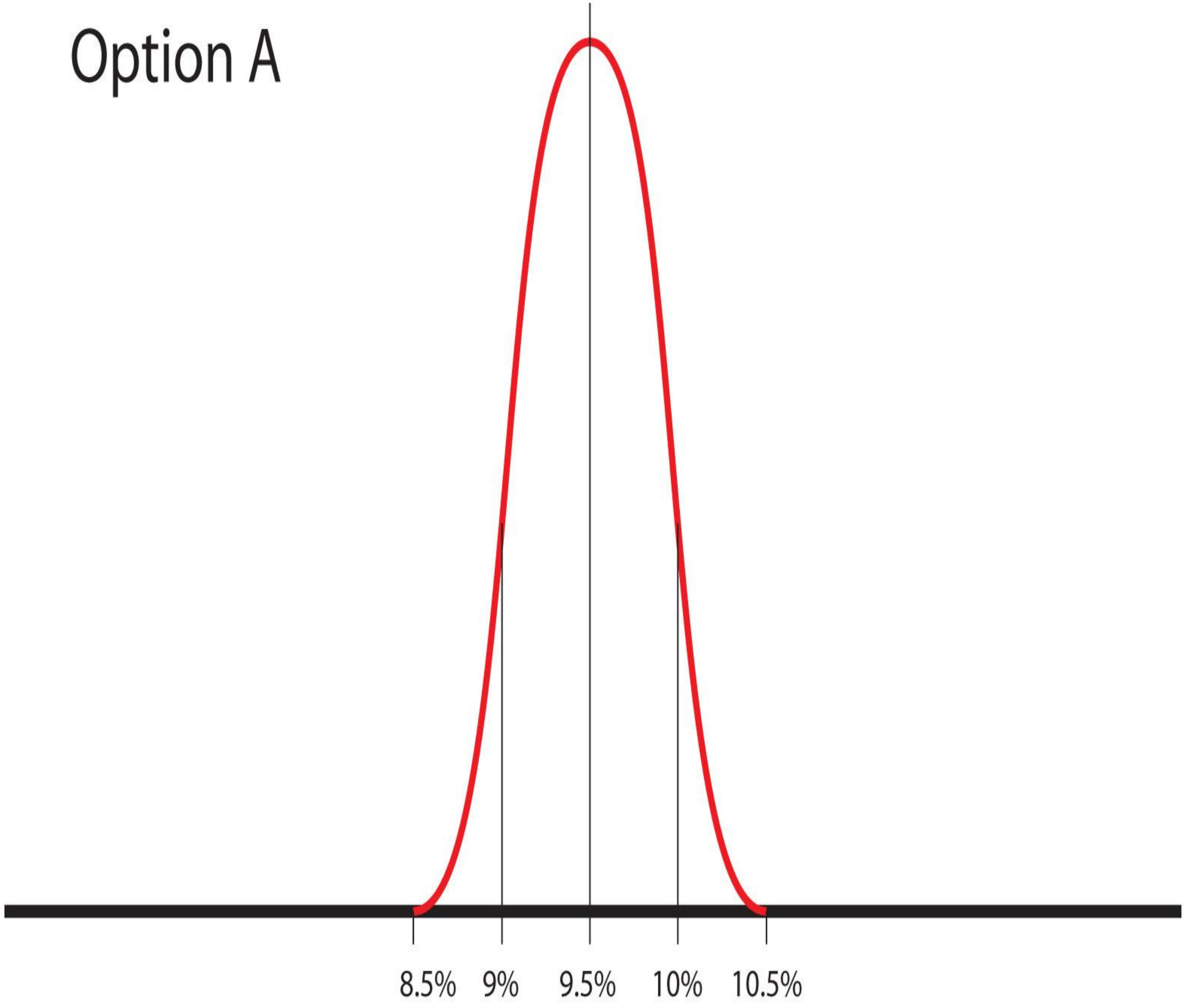
- There are 'three legs to a stool'. Please rank: your family, your clients, your suppliers.

Thoughts About Alignment

- Fee-based advisors can say “I do well when you do well -and I suffer when you do, too”.

- Beyond reproach regarding the motive behind any product recommendation

- In short, depending on how sensitive you are to options that are “good enough”, managing costs, being transparent, aligning interests, being potentially deductible are all elements of what might one day be part of a best interests standard.



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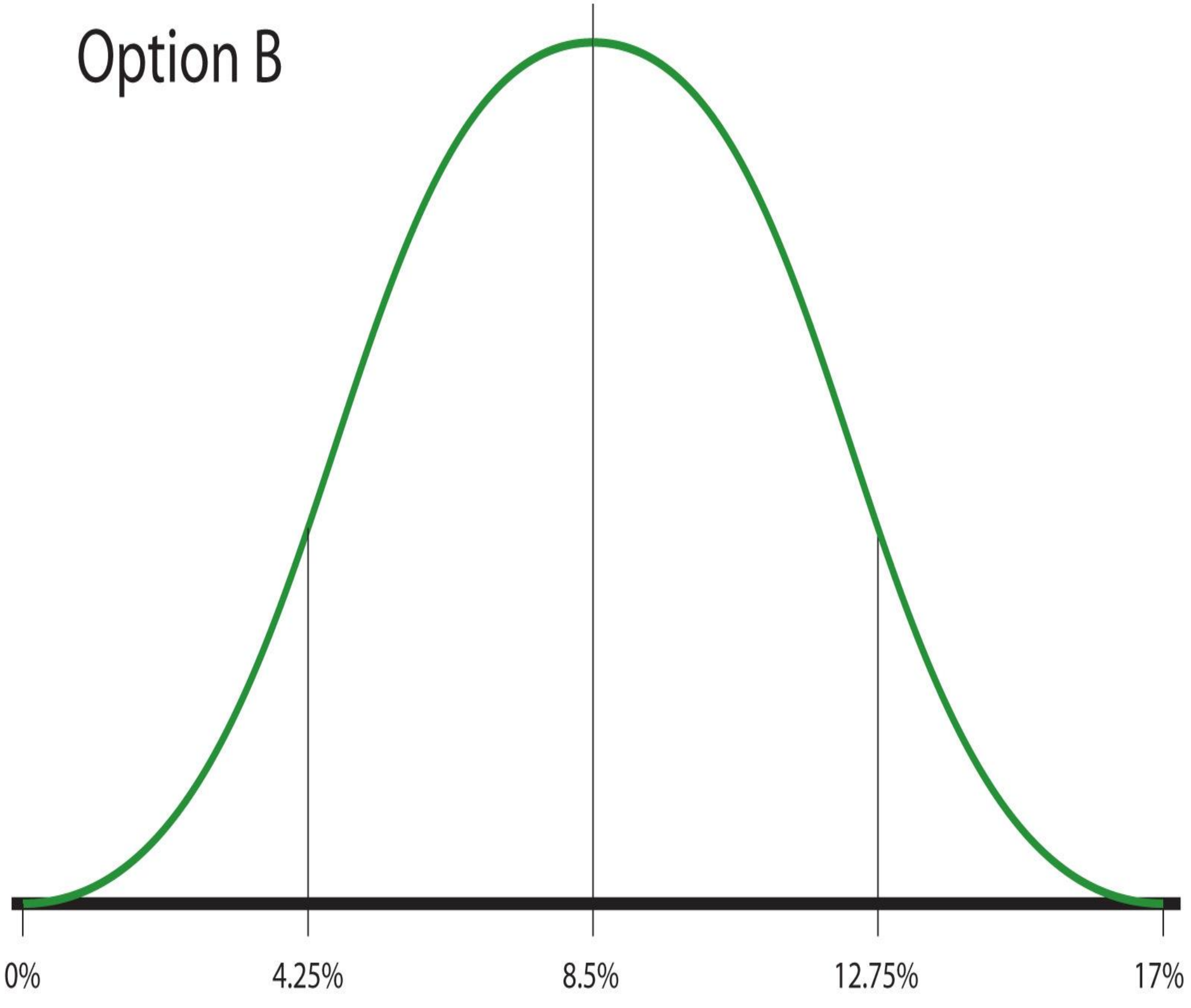

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Choice Based on Informed Consent

Option A:

Statistically stronger probability of return

Option B:

Pursuit of the positive outlier

What’s your preference?

I did a Presentation to the Public…

- When I showed them these two distribution options, about 80% (out of maybe 40 people) chose Option A.
- My best guess is that over 90% of all investments today are using the paradigm set out in Option B.
- If we do what is in our clients’ best interests, please explain the disconnect.
- Do you offer Option A to your clients?

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Focus on what you can control

- Take responsibility for clients' portfolio costs, turnover and / or trading activity, asset allocation and behaviour.

- Do not take responsibility for picking stocks, picking funds or timing markets. I don't believe I can do it (reliably). With respect, I don't think others can, either.*

* Research done by Michael Jensen in the 1960s and Mark Carhart in the 1990s shows that past performance does not persist and that outperformers cannot be reliably identified in advance.

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What Does Peter Lynch say?

All the time and effort that people devote to picking the right fund, the hot hand, the great manager, have in most cases led to no advantage.

Peter Lynch, Beating the Street, (New York: Simon and Schuster, 1993)

What does William F. Sharpe say?

"Properly measured, the average actively managed dollar *must* under perform the average passively managed dollar, net of costs. Empirical analyses that appear to refute this principle are guilty of improper measurement."

William F. Sharpe, The Arithmetic of Active Management, FAJ, Volume 47, Number 1, January/ February 1991, pp.7-9

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What did Paul Samuelson say?

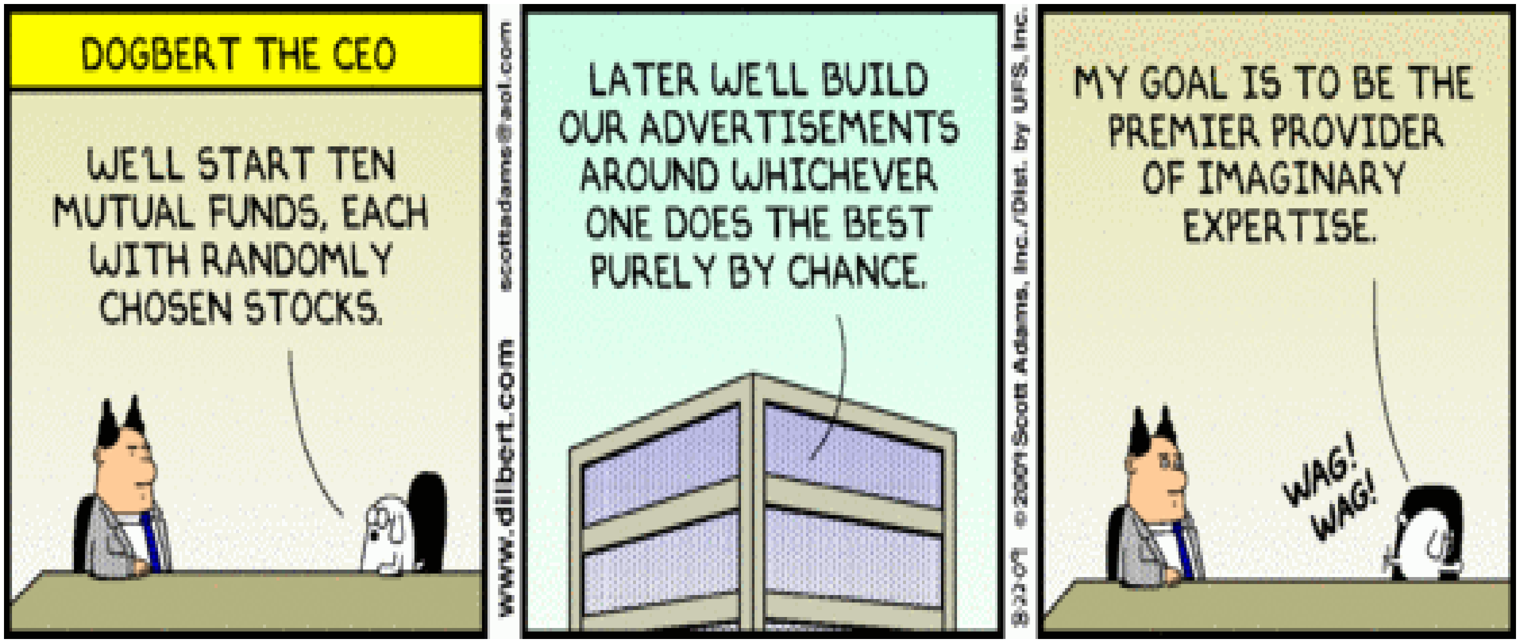
"Ten thousand money managers all look equally good or bad. Each expects to do 3% better than the mob. Each has put together a convincing story. After the fact, hardly 10 out of 10,000 perform in a way that convinces an experienced student of inductive evidence that a long-term edge over indexing is likely."

Samuelson won the Nobel Prize in Economics in 1970

What Does Warren Buffett say?

"Most investors, both institutional and individual, will find that the best way to own common stocks is through an index mutual fund that charges minimal fees."

Warren Buffett, Berkshire Hathaway Inc. 1996 Annual Report (Chairman's Letter)



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Maybe Core/Satellite Works

- Could have a “core” of 50% to 90% that’s cheap, pure, broadly-diversified and tax-effective
- Add on “satellites” based on individual securities, favoured managers, sectors, market timing, etc.
- So much depends on the values and tendencies of advisors, clients and other stakeholders. There is no single, definitive correct way to ‘run the money’.

A little test about Overconfidence

- Are you an above-average driver?
- Are you an above-average planner?
- In nearly 20 years in the business, I have yet to meet a single mutual fund manager who admits to being “below average” … yet, by definition, about half of them are!
- It’s actually worse, after taking into account costs, about 80% to 90% of them lag their benchmark.

We can’t all be above average

- Only a small fraction (~10%?) of all actively-managed funds have a long term (10+ years) track record that beats the benchmark

- Those that end up in that minority group cannot be reliably identified in advance and do not persist

- Research from Standard and Poor’s: “SPIVA” reports come out semi-annually, but only for 5-year time horizons

Portfolio Turnover

- A potential “silent killer”… for taxable accounts, many fail to consider tax implications of trading.
- After-tax returns can lead to quite different rankings of competing products- mandatory in the U.S.
- Typically over 50% for active mutual funds; typically under 10% for ETFs and index funds.

Scientific Testing

- Many studies on the subject have shown that cost and performance are negatively correlated and that the impact is often ‘material’.

- Do advisors disclose that today? Will they in the future?

- How professional is it to willfully *not disclose* material facts that will assist clients in making an informed decision?

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And now for the ‘D’… Disclose

- Were you aware of the things mentioned in the previous slides? Are your clients aware of those things? Do we tell investors about the ABCs of investing?

- Not suggesting anyone is lying, they’re simply failing to actively tell the truth.

How to Disclose

- Clients need to understand both HOW and HOW MUCH you get paid
- Compensation is put in writing (3 or 4 Options)
- Philosophy can be put in writing, too
- Broad investment options (frequency and degree)

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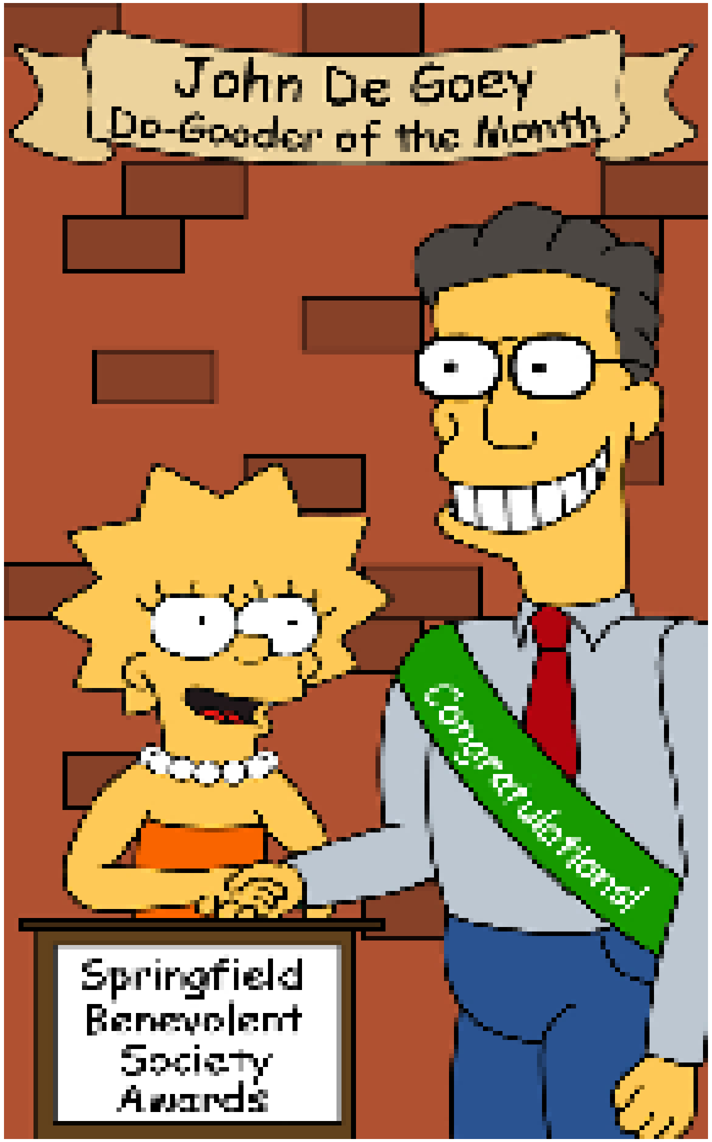
Disclaim and Disclose

All *major facts should be disclosed* so clients can make an informed decision.

All *personal opinions should be disclaimed* so that clients are sure to recognize them as opinions.

What if it is less than obvious whether or not the matter being questioned is a fact or an opinion? Take the debate between evolution and creation…. educators have chosen to teach both and advocate neither.



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Purposeful Change

- Who here saw "Lincoln"? My sense is that the 'stars aligned' in order to get the 13th amendment passed in the 1860s.

- Perhaps it could have happened 10 years sooner; perhaps it would have happened 10 years later, but looking back from 2013, the ultimate outcome (abolition of slavery) seems to have been inevitable.

- How do the history books treat the people who resist change?

The Debate Surrounding Statutory Best Interests

- I think “statutory” means next to nothing to average Canadians.

- What matters to them is that advisors put their interests first. Voluntary protection still beats no protection.

- We have an opportunity to initiate a voluntary best interests standard.

Why? And Why Now?

- It is never the wrong time to do the right thing.
- The history books will be kind to us.
- We will gain an ‘early mover’ advantage over old-school advisors who are less professional. Clients will be attracted to us for our decency and will reject those who are unwilling to give similar assurances.
- The change is inevitably coming, anyway.

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The Fiduciary Pledge

- I, the undersigned, pledge to exercise my best efforts to always act in good faith and in the best interests of my client, ____________________________. As such, I will act as a fiduciary at all times. In particular, I will provide written disclosure, in advance, of any conflicts of interest which could reasonably compromise the impartiality of my advice. I will offer evidence–based rationales for the product recommendations I make and I will make written disclosures of any and all payments I receive as a result of my role.

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Disclaimer

The views expressed are those of John J. De Goey and are not necessarily shared by Burgeonvest Bick Securities Limited (BBSL). Debate regarding market efficiency, the usefulness of fundamental and technical analysis, active vs. passive management and the efficiency of fee payments is ongoing. To date, neither side of these debates has been able to claim unchallenged victory. BBSL as a policy, supports both active and passive approaches as well as fee based and commission based practices.

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