The Problems with Investment Advice

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Recently there has been considerable discussion revolving around a package of reforms to investment advice (FOFA or the Future of Financial Advice). This initiative reflects a considerable degree of dissatisfaction with the performance of the industry. It is the purpose of this paper to consider whether the reforms are adequate to deal with the causes of this dissatisfaction. The first step in this process is to outline the FOFA reforms. The second step is to identify the desirable characteristics of investment advising. The third step is to consider any further reforms which appear to be necessary. This section will also suggest an appropriate approach to the provision of financial advice.

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, e.g. income, wealth, age, marital status, number and age of children, objectives, etc.

The paper may appear to reflect a very negative attitude towards the investment advice industry. However, it should be recognised 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 contributor to 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:

- a lack of knowledge of investment vehicles and institutions and a general lack of financial and investment literacy;

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- time constraints which prevent investors from devoting sufficient time to managing their investments; and

- there is considerable evidence that investors are irrational in making investment choices—they are "loss averse", 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) and Valentine et. al. (2011, pp 251 – 252). It is also reflected in the number of investors who are taken in by such scams as Ponzi schemes and Nigerian letters.

Competent investment advice would help investors to overcome these problems.

The FOFA Reforms

Most of the FOFA reforms apply from 1 July, 2013. A good summary of them is provided by Bateman and Kingston (2012). A last minute addition to the reforms has been 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 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 the client to ensure that they understand his/her position within reasonable constraints.

A major part of this commitment is the banning of remuneration structures which create conflicts of interest, i.e. incentives to ignore the client's interests in making recommendations (see ASIC Regulatory Guide 246). FOFA rules out:

- incentive payments from providers based on the volume of business written;

- "soft-dollar payments" (e.g. 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, i.e. they can continue into the future.

Also, 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.

Advisers must also justify their recommendations, demonstrating that they 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 in itself could act as an incentive for clients not to access the available information.

A "retail client" is most simply defined as one who is not a wholesale client. The latter category includes a long list of business owners, professional investors, etc. but most notably an individual who for the last two years has earned $250 000 p.a. (gross) or has net assets larger than $2.5m. 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 focussed on tax minimisation.

This model will cause a shift towards up-front 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, i.e. fees based on the return earned on the recommended portfolio. If so, this could have the effect by creating an incentive for recommending over-geared or otherwise risky portfolios which could yield very high returns.

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.

A Desirable Approach to Investment Advice

Investment advice should be tailored to the position of the client. This means that "one approach fits all" is unlikely to be the correct approach. It is unlikely that you will find any two individuals who have exactly the same characteristics in the areas mentioned in the first 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 aims and 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 which are intended to be used 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, a car, etc. 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, any 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 illustrate this point very clearly.

It is often asserted that advisors 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. Such questionnaires have two advantages, namely:

- they provide documentation showing that the adviser has taken steps to ascertain a client's attitudes to risk, documentation which will be useful in any future legal action; and

- it is a very simple and not time-consuming way to satisfy this requirement.

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 return to any other asset with a much higher average return which produces an occasional negative return. Also, the term "risk profile" implies that the questionnaires establish the investor's trade-off between risk and return, but few questions in the questionnaires offer the respondent a choice between assets with different risk/return characteristics;

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

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

There seems little reason to continue to use risk profiling questionnaires.

In view of these weaknesses, 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. In particular, the adviser should identify subsets of the client's assets which are intended for specific purposes;

- the adviser should discuss investment alternatives with the client to obtain information on the latter's basic attitudes to investment—is the client loss averse, what is the client's attitude to borrowing for investment purposes, etc?

- 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.

An important element of this process is to educate investors about what they should do in their long-term best interest. 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 yield high average returns over long periods even though they suffer an occasional year of negative returns. Shares and property are the obvious candidates.

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.

Investors' risk management would also be supported by ASIC adopting a more stringent attitude to draft prospectuses submitted to it. Recently it approved a fund (and the SRE of that fund) which was targeting individual investors albeit ones whose accountant was willing to provide a statement asserting that they were sophisticated investors. In reality no attempt is made to test the validity of such assertions. The fund in question was selling sold option straddles on shares, i.e. put and call options on the same share are sold. This is a position with a limited upside and an unlimited downside. Basically, it is an accident waiting to happen. In the case concerned the accident took only a few weeks to occur – option prices "gapped" over a weekend and the fund was wiped out. ASIC needs to raise its level of expertise so that such products are not allowed on the market. In particular, it needs to provide its employees with more advanced financial training than currently appears to be the case.

ASIC could also 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 do not make extensive use of them themselves. 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 regularly report 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 which could be used are the Sharpe index and Jensen's alpha (see Valentine and Scott (2012, pp. 166 – 169)).

It has already been suggested that the way in which investment advisers are 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 counter-productive impacts. First, it encouraged advisers to recommend some very risky investments which paid a high commission simply because they were risky.

Secondly, 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.

Thirdly, advisers did not direct clients' attention to attractive alternatives because they 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.

Clearly, a fee-for-service method of charging removes these conflicts of interest. However, there is a downside to his approach. Many investors have a resistance to paying an upfront fee—they imagine that they are getting "free advice" if no such fee is charged. Requiring such a fee could have the unintended consequence of deterring many investors from seeking professional advice although they are seriously in need of it.

An alternative to charging a single upfront fee (perhaps based on an estimate of the size of the job) plus an asset based fee would be for the profession to go over to a "billable hours" approach similar to the one used by the legal profession. The client would then need to be given an estimate of the likely cost of the service.

This approach has some advantages. Specifically:

- the fee is based on the actual work done which will not be the case if part of the fee is determined by asset size; and

- clients with simple tasks will be able to have them performed inexpensively.

However, participants in the industry would probably resist the adoption of this approach. Advisers would be concerned about the additional administrative requirements it would create and clients would be concerned that the number of billable hours could be padded out.

Investment advisers are often criticised for recommending tax-effective products. It is argued that in considering these products in sufficient attention is given to their basic soundness. There are certainly examples which provide support for these views. A return to the artificial products of earlier times is certainly not to be desired, 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.

A major conflict of interest in the industry is the fact that product providers (e.g. banks and insurance companies) own investment advisory services. 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 which avoids significant reliance on commissions, which gives them a competitive advantage over independent and independently owned firms. It, therefore, appears that opportunities for obtaining truly independent advice are diminishing. The competitive advantage is enhanced by the decision to allow platform holders to pay an extra 0.2% of assets on the platform to advisers. This does not appear to concern the regulators who (as is usually the case) prefer to deal with a few large players rather than a large number of smaller firms.

What Remains to Be Done?

The FOFA reforms have failed to address a number of serious problems in the investment advising industry. One – the potential conflict of interest when an advisory firm is owned by a product provider – has been discussed. This omission could lead to a reduction in the availability of independent investment advice. Another problem is that organisations who 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 it 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.

There is also a question of the educational qualifications that investment advisers should be required to have. This question 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 has occurred. Such a test is likely to be based on the nuts and bolts 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. It should also be useful if ASIC regularly audited some randomly selected SOAs.

A framework for advice was discussed in the previous section. 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 point out that it is extremely difficult to diversify a small real estate portfolio. In such cases an investor who favours property can achieve diversification by investing in a portfolio of property funds. This is particularly important for managers of SMSFs which, given the recent changes in regulations, are apparently being attracted into undiversified property portfolios. Indeed, managers of SMSFs should receive a separate booklet explaining the management of such a fund.

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, in general, a step in the right direction, but do not go far enough. It does not tackle the problem of the conflict of interest involved in the provision of investment advice by product providers. It also leaves a fragmented industry in which people giving different types of investment advice are subject to different regulatory regimes. It would be desirable to create an integrated industry. It would also be desirable to raise the professional quality of members of the industry, especially by raising educational requirements. A major concern is to provide the investing public with information and education. In doing so, the process should not involve complex and routine documents that clients will not read.

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