After The Descent, What Colour The Phoenix?

A perspective on the development of integrated wealth management processes in the Canadian Retail Financial Services Industry

Part 2 d – Financial/Economic Crisis Related Issues – Costs and the Active v Passive debate

An industry highly dependent on transactions for remuneration and a transaction remunerated sales force for distribution is likely to come under stress as demand for products and transactions decline in response to an evolving financial, market and economic crisis.

In the light of significant and sustained falls in global markets and low bond yields, issues of cost and value for money are also likely to become increasingly important for both investors and advisors: high costs are impacting those dependent, or soon to be dependent, on their assets for their short and long term financial security and the credibility and viability of higher cost retail wealth management solutions.

When talking about costs, in the current context, we are generally talking about two things: the costs of production (service and distribution costs) and the costs faced by investors; the latter being influenced by the former.

How long the industry will continue with its current cost structure and distribution framework in the light of current conditions is a moot point, but poor returns to investors is not sufficient reason (*in terms competitive markets*) alone for an industry to reduce costs.

> It is important to note that cost structures and distribution frameworks are a function of the competitive environment: technology, regulation, preferences and demand for services, transactions and products and industry structure and operating environment all determine cost and distribution. A significant change in one or more components impacts cost structures and distribution frameworks via its impact on overall competition.

A concentrated banking industry, the importance of sales distribution (*advisors with historically strong pricing power*), relatively weak investor protection and regulation that supports a transaction based framework, have all helped keep costs high and a legacy transaction driven structure intact; current conditions are pressuring this cost and transaction driven structure, the credibility of services provided by such structure and is leading to over capacity in the industry, including and not limited to an over supply of salespeople/advisors; these are all factors that could lead to a restructuring and refocusing of the industry.

While many in the Canadian retail financial services industry would not wish to publicly acknowledge many of the industry's competitive characteristics, being aware of their implications and being able to mitigate the risks they pose is a different thing entirely.

Costs and brand liabilities

As it is, in the current environment, portfolios (*many of which may also be poorly structured*) with high costs will be depleting rapidly: this is a brand liability to all companies that are looking to position themselves as credible providers of retirement income planning solutions and longer term wealth management - inability to adapt and react to the demands of the environment also represent a further brand liability.

For many advisors, their sole reason for being is the perception that they are able to offer solutions, products, strategies, plans that can provide returns, manage risk and add value. The current financial, market and economic crisis is seriously impacting that perception, and companies and advisors that want to survive in the market place will need to find ways to re-establish their credibility and to prove they can indeed deliver.

If perception of value is being challenged and the cost and distribution structure of an industry is exposed, there are opportunities for those who wish to exploit this: businesses operating integrated, standardised processes will have lower breakeven points (*lower costs associated with integration and automation as well as the benefits of lower compliance and other costs*), and will be able to compete at a higher level on value and service. Higher cost businesses with legacy frameworks may not be able to adapt as quickly and so companies need to look at factors impacting their ability to adapt to changing conditions.

Pressure on costs from all angles

But just as companies should be looking to be more efficient and relevant, then so should advisors; likewise, if governments are looking to stimulate demand and investment in the current environment, then they may also be interested in promoting lower cost financial services. The drive towards more efficient processes should (*but not necessarily will*) therefore be coming from all angles.

Costs and integrated processes

The thrust of all the perspectives (*in the current series*) is that services based on integrated business and service processes allow the fixed costs of delivering wealth management solutions to fall, for greater value to be added to client services and solutions, and for costing and costs to shift from the transaction to the service. It is worthwhile noting - not that this is necessarily going to translate to Canadian regulation - that in the UK regulators will soon be introducing new rules that separate the cost of the advice from the transaction and that in this market place companies that want to survive will have to adopt processes and systems that can accommodate this shift – that is to shift charging from the transaction to the service, something which is required if you are to move from the transaction to an integrated service based process.

> Integrated service based processes have different form and content, and advisors have different relationships, roles and responsibilities; all of this is a break with a transaction driven structure; the next phase of industry development is more complex than a simple product launch and may take years for a transition to successfully and finally implemented.

High costs, whether they are the fixed costs of distribution or the cost of a product to the investor, are quite rightly an Achilles heel in a declining and/or competitive market place: they (*costs*) are a function of competitive structure and cannot be unwound without first altering key components and relationships of a competitive framework. Costs of advice, and hence operational costs of distribution, in the Canadian market place are high in global terms, and room for costs to fall as competition unfolds are therefore greater: this also means that the impact of a changing competitive environment are going to be significant for Canadian retail financial services.

A quick fix or a fundamental change

Reducing costs and enhancing service quality are important means to enhance brand perception; in the current climate, changes may well need to be substantial and measurable to truly differentiate oneself in the face of the consumer as well as advisors looking for competitive service platforms. While many marketing departments may be looking to the next product that can capture the imagination of their sales force, they should also be looking at how to make their distribution arms more relevant and more productive: these are strategic and structural issues that in most instances transcend shorter term sales and marketing objectives.

Costs & Competition

Costs are a competitive benchmark: cutting costs and enhancing productivity are key to growth in profitability; in a market with declining demand, productivity growth and the ability to expand margins on smaller volume is the only way to grow earnings.

Companies in competitive markets should be looking to lower costs (*to raise margins*) by enhancing productivity (*use of technology and improved processes*) and looking for ways to enhance value to purchasers of products and services (*to increase demand for their output and raise barriers to competition*).

A number of factors can impact the ability to lower costs and enhance value: in the financial services market place this can be affected by the ability of independent distributors to influence the price they are paid for distributing product, services and transactions; the competition for these distributors and their ability and willingness to adapt to improvements in technology and processes.

> If as a middle man you can influence the price you get paid for your services while at the same time controlling the time and effort expended in delivering the final solution, you will have an economic interest to continue to do so. Additionally, product and service design can also be influenced by the needs of these distributors.

The ability of the distribution channel to affect pricing and value added is also determined by the competition in their (*distributors*) own market place (*which one would assume is becoming more competitive*) and the ability of their consumers to impact pricing and value added via their own purchase decisions. Other important factors are as follows:

- Regulatory changes impacting transparency over service, risk and return, value and pricing that would affect competition in the market place.

- Changes in the demand for and or supply of products and services that would force suppliers and distributors to cut costs, increase productivity and to look at ways of adding value.

- The % of the market place met by fee or % of assets under management, who are not rewarded for transactions, and the % of the market place remunerated by transaction returns: the lower the % of the market rewarded by the transaction the more the more the supplier of the product and the transaction has to compete on price and added value and vice versa.

- The extent to which technology and processes are integrated and the extent to which independent distributors are barriers to integration of wealth management processes. One of the reasons for the survival of a large transaction based component is the cost and complexity of delivering a wealth management solution to retirement income planning: this problem is likely to be obviated by developments in processes and application of technology.

- The ability to access investors directly[1]: wealth management is a complex area, while there are many low cost investment solutions available, not all investors have the confidence, expertise or knowledge to take advantage of these solutions; technological advances and integrated processes may make it easier to deliver total wealth management solutions direct to the investor while providing all and more of the benefits that a personal relationship would have provided.

- Anything which predicates a movement away from a predominantly transaction based industry to a service process based wealth management approach will result in greater use of technology, higher levels of integration of all components of the wealth management process (*asset management, investment planning, client relationship management and the business and service process*), lower costs and higher added value.

Firms need to keep an eye on competitive developments within the industry *(including regulatory as well as possible influences on regulatory change),* their own cost structures, their own ability to adapt to changes in the competitive framework and the views of their own advisors/distribution relationships.

Principal/Agency risk and costs

One other factor can impact a firm's ability to increase productivity over time: part of today's problems in the financial sector can be attributed to agency risk. Product and services solutions, business and service frameworks should be directed towards maximising short and long term shareholder returns and agents should be compensated for working towards and achieving these objectives: business strategy and product development should not benefit short term returns to the agent to the detriment of long term returns to shareholders.

Cost paradigms

While the average mutual fund MER in Canada is amongst the highest in the world[2], there are services within the Canadian market place that allow individual investors to sidestep advisors and purchase lower cost portfolio options that compete directly with the services provided by advisors, including investment counsellors: ING Direct provide low cost index ETF portfolio options, RBC provide low cost mutual funds

[1] Investors can already directly purchase balanced, structured portfolio management with ETFs for 1% per annum and low cost actively managed mutual funds for the same annual % cost with recommended asset allocations for different risk profiles..

[2] Mutual Fund Fees around the world, Khorana, Servaes, Tufano - http://papers.ssrn.com/sol3/papers.cfm?abstract_id=901023

with a range of portfolio asset allocations for on line investors to build a portfolio appropriate for themselves.

In the US many of the same funds on offer in Canada can be purchased direct for a fraction of the costs: note the Fidelity Replacement Income portfolios that are only accessible via advisors in Canada but can be purchased direct by consumers in the US.

Likewise, within the advisor spectrum there are lower cost investment counsellors. As discussed in the perspective dealing with advisor roles (*and addressed in perspectives dealing with integrated business and service processes and systems)*, the introduction of more sophisticated systems and processes are likely to break down the barriers to delivering sophisticated wealth management solutions to all investor profiles, one the major reasons why a transaction based industry has survived in its current form to date.

Changes in regulatory and other components of the competitive framework would impact the financial services framework in Canada. The question is how do companies shift from a transaction to a service based structure without upsetting distribution and revenue? Specific consultancy and market research projects would address these very issues.

Long term trends

There is no doubt that the Canadian market place is opening up to cost arguments at the margin, and in the current environment, costs to investors and the associated credibility of advisors and institutions is a much more potent imperative.

Historically mutual fund fees (a proxy for industry costs) have shown a tendency to rise over periods associated with growth in the financial services industry[3] and the cult of the equity and the lure of the promises of active management have certainly made increases in actively managed fund expenses much easier.

But, we are no longer in a period of rising equity markets (*markets are at or close to decade plus lows*); we are no longer in a period of strong growth in the financial services market place (*from banks to insurance companies to mutual fund companies, the industry is under pressure*); we are no longer in a period of rising demand for distribution (*this has probably long since peaked and lower cost sophisticated distribution solutions are likely to be the way forward*).

If distribution has been a factor raising costs in the Canadian market place, then in the current environment distribution may well lose its ability to control pricing. We are also likely to see a rise in the use of technology and standardization and integration of processes, creating further room for cuts in costs.

[3] http://www.morningstar.ca/globalhome/Industry/News.asp?Articleid=ArticleID6620031641, http://finance.yahoo.com/funds/how_to_choose/article/100549/Rising_Expense_Ratios

Cost Reduction & transition

If firms are going to reduce costs and expenses on products and transactions, they need to make sure that they provide leeway for their advisor base (*distribution*) to transition into the new operating environment. One of the ways would be to provide an enhanced service infrastructure that will allow advisors to compete more effectively in the market place while optimising their own productivity. Strategies for structuring and implementing change are not part of this perspective, but are part of specific consultancy options.

Wealth management/cost/benefit responsibilities/brand risks

As soon as an institution starts to sell products, solutions and services that promise to manage the risk of depleting capital within an investor's lifetime and to provide, with varying degree, income and capital security, it also implicitly becomes responsible for the cost/benefit relationship. Positioning within this spectrum is risk management/brand positioning exercise.

Costs represent one of the greatest risks to an investor's short and long term financial security, and, in a low to negative return environment, also represent increasing risks to a wealth management brand: note that a promise of a long term benefit from a service is different from the singular perception sold with a transaction; investors/clients may get lost in the maze of successive transactions, but a longer term service promise/expectation creates an indelible line in the sand. In this line, costs and value are more clearly marked.

- High costs impact the level and sustainability of withdrawals and impact the level of risk to which investors are exposed in down markets. Moving into processes that manage the accumulation and depletion/consumption of capital means that services and product providers, in competitive markets, are eventually going to have to compete on costs, or at least the level of transparency with respect to those costs.

- We have had a decade or more of poor returns for retail investors, a negative that will have been accentuated by high costs and will continue to be so. The current market and economic crisis will see a fall in demand for retail financial services as well a rise in demand for better value.

The future may pose a dilemma for many product providers: they will need to decide which market place they are looking to cater to, given that each niche or expectation has its own liabilities. Are they looking to meet the demand of transaction sellers, or the provision of solutions, products, processes and platforms that help advisors or other service providers meet the wealth management (*including retirement income planning*) needs of investors? These are different markets, and in the marketing context have different brand associations. Additionally, once these markets start to develop, it is likely that changing cost paradigms will impact the costs and margins of those focussed on the sale of transactions, further marginalising the transaction driven sections of the business.

Integrated business and service processes and costs

While the range of options available for the development of sophisticated business and service processes may be wide, one thing is clear, centralisation and integration of processes could result in a push towards institutional like fixed costs and hence the potential, over time, for institutional like investment costs for investors.

The move towards process will involve the integration and automation of much of the business and service process: technology will allow all areas of the business and service processes to be integrated and all decision rules and disciplines used by the organisation to be hard coded into a wealth management service solution system. The costs of all the component areas of the business and service process will come down, as will the need for manpower.

Active/Passive Management Debate

The active passive investment debate has been largely marginalised by the retail financial services industry in Canada, but the arguments associated with low cost indexed investment are gaining traction.

Costs are one of the key reasons why active management is so often maligned; a move towards integrated process based service solutions (*shifting cost and charges from the transaction to the service*) would on the one hand enhance the rationale for actively managed funds and on the other could further detract from the viability of much of the actively managed industry. Those who rely on actively managed mutual funds for delivering wealth management solutions or those who rely on active management as their core business will need to be aware of the dynamics of integrated asset and liability management processes and how this will effect their businesses.

It is a moot point whether or not the industry can continue to operate on the current basis, given the very large mauling handed out to unit holders of high cost collective investment vehicles (mutual funds). Costs matter more in falling markets.

While the allocation to passive indexed investment strategies has been more readily accepted by the institutional mandate, indexed based investment strategies in the Canadian retail financial services market place still occupy a very small piece of the pie: distribution of advice/products still remains largely dominated by a higher cost personal relationship transaction based model.

It is expected that the issue of active versus passive will become much more of an issue as investors and service providers focus on processes and service platforms as opposed to transactions and hot products. Again, while publicly the retail financial services industry as a whole may not accede to many of the concerns over high mutual fund and other product expenses, this does not mean that they should not be looking at risks to the business model and ways of adapting to a different market environment.

Active versus passive, the numbers

There is a plethora of research and data on the poor relative performance of actively managed investment vehicles. While the TAMRIS Consultancy certainly believes that it is possible to out perform (*over the long term, but not consistently at all points in time*) via non passive equity management, this can only be achieved by taking significant contrary positions to the market, and only by the few.

Small changes in equity allocation can have significant changes on share prices: assuming a 10% cash, 30% bond and 60% market portfolio and no new net money inflows to the market portfolio, a 0.5% change in cash allocation (sale transaction) would cause the equity market to fall 8% and its reallocation would cause the market to rise 8%. If the sale transaction is based on a sector comprising 30% of the index this would equate to a 27% decline and if the purchase transaction was allocated to a sector comprising 10% of the index, this would equate to an 80% rise. In other words if you want to sell, you can only really sell when there is positive money flow, and if you want to buy low you must be one of the few doing it otherwise the price will move against you.

In order to succeed in active (*non passive*) management you either need to be the first to buy and sell with good demand for those shares on the sale, or you need to be able to take a long term view to the contrary market positions you hold – note that the market allocation will be comprised of those who hold broadly based as well as significantly over weighted portfolios. We know that market timing for a number of reasons is extremely difficult to engineer successfully and consistently (*Capitalism in Crisis 3 looks at the physics of market timing*) which means that in order to out perform you most likely need to be able to build up long term positions in under valued investments: in other words, a valuation driven style with very low levels of trading, and where trading occurs, contrary to the direction of the market.

In truth only a small percentage of the market place is going to be able to successfully implement contrary non passive indexed investment strategies. But why is this relevant to collective investment vehicles (including mutual funds).

Let us assume a market rate of return 10% per annum, a mutual fund with an active MER of 2.5% p.a. and transaction costs of 0.8% p.a. and an ETF with total costs of MER 0.25% + transaction costs of 0.1%.

If an active fund with these costs were to differ from the index in its asset allocation by say 20%, the difference in asset allocation would need to earn a return of 25% (*250% of the market return*) for the fund to equal the ETF index return. Even a 40% allocation difference would require that this component produce a return of some 17.5% or 175% of the index return.

This does not mean that active strategies do not have a place, just that a) the amount that can be allocated to active strategies can only be marginal, b) that costs need to be low and c) that active strategies need to be significantly different from the market to provide the opportunity for sustained long term out performance.

It goes without saying that most mutual funds are not capable of adding value given their costs and the fact that asset allocation profiles do not deviate sufficiently from the index to provide the opportunity to out perform.

At some point in time the industry will need to take note of the impact on costs of the efficacy of their overall wealth management solutions. If the progression is towards process and integrated solutions with responsibility for the structure, strategy and risk management methodology moving back towards institutions (*in the current transaction based segment populated by investment advisors*) then costs will need to come down.

The value argument

Advanced processes can deliver high value added to what were once simple portfolio structures. There is no reason why the industry cannot move towards an integrated service based process and to transfer pricing to the service and its content and away from the transaction. While fee based accounts have attempted to do this, they more often than not a) lack an enhanced value added component and b) provide little or no cost reduction because they have remained within a transaction based framework.

Decision tree

As will be discussed in brands and their relationship with wealth management/retirement income planning business objectives, the more significant the deviation between the expected or promised outcome and the actual outcome, the greater the risk to brand. It is the same with respect to the impact of costs to consumers of services and products. Charging a higher fee should only be made if the impact of that higher fee over time is less than the additional return earned by that fee. Likewise with changing the distribution framework (*transaction to integrated service*) and increasing productivity/return on capital, the additional returns of change to a different service structure must outweigh the risks of that change.

As discussed in advisor roles, the two key factors impacting change are a) the current financial market and economic environment, and b) the drive towards establishing a strong retirement income planning brand. Both factors emphasise the importance of processes and increase the risks to brand of deviations between promised/expected outcomes and actual outcomes. Lowering operational costs, increasing margins, adding value, transferring remuneration from the transaction to the service all provide greater leeway to meet corporate (*profitability, growth, market share*), distribution *(loyalty and retention of key advisors)* and client objectives.

But when looking at costs, participants in the market place must ensure that their operational framework can adjust to a changing competitive environment. Those caught in a transaction framework while others are in the process of moving towards an integrated service based process are more likely to be significantly and financially impacted.

Summary

There are a number of factors which have influenced the structure and costs of the Canadian retail financial services market place. It should be clear that current changes in the competitive landscape will directly impact issues of cost and structure.

Technology will be a force for lowering costs of production and of increasing margins and facilitating a move away from a transaction based industry to a standardised, integrated business and service process, but technology is only a secondary force.

Any changes in regulation are also likely to impact a move away from transaction based industry structures: attempts by the OSC and the Fair Dealing Model to effect change that would impact the industry were unsuccessful, but this does not mean that change will not eventually come.

The current financial, market and economic crisis is creating an imperative for change: investors with high cost or poorly structured, planned and or managed portfolios pose a risk for those who do not react to the need for efficient solutions and an opportunity for those who do.

The drive towards more sophisticated retirement income planning solutions is forcing companies not only into process and away from simple stand alone transactions, but into accepting the responsibilities associated with developing credibility in this market place.

As perspective on differences between transaction and integrated service based processes will show, restoring and developing credibility in wealth management (in particular retirement income planning) will take more than changing the décor or the message. Understanding the full decision tree and the risks associated with change will better help those deciding on change.

As a thought leader document this perspective introduces issues associated with industry costs. Future research will address trends in costs and changes (*technology, product/services, regulatory, consumer needs and preferences, financial/market/economic environment*) likely to impact costs in both its relevant forms (margins and consumer costs).

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