

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 – Financial/Economic Crisis Related Issues

The current financial market and economic crisis has raised a number of questions over the efficacy of the current financial services product and services' distribution framework: is it appropriate and efficient in terms of its ability to meet consumer needs, brand expectations, shareholder interests and capital market efficiency?

- ✚ Market timing, the value of buy and hold strategies and their sensitivity to the management of short term income and capital security: though we are only a short way into the crisis mean variance efficiency and diversification **alone** have been found wanting in terms of managing income and capital security risks.
 - More attention to structure, is needed, in the context of managing the risks to the ability of assets to provide income and capital security outside of the modern portfolio theory model and the limited retail solution.
- ✚ The viability of investment planning and risk modelling tools that rely on assumptions of market efficiency and long term average return assumptions irrespective of the stage of the market and economic cycle.
 - Planning tools and assumptions and risk management methodology have been found wanting and income and capital security subject to significant risk because of them. Firms will need to address these risks if they want to counter the unfolding credibility gap.
- ✚ The role of advisors in the crisis and beyond and the viability of the current advisor product/service distribution, remuneration and advisor/institution operational relationship models¹.
 - The management of integrated asset and liability management solutions requires significant expertise (across a wide variety of disciplines), sophisticated systems and resources: individual advisors cannot possibly achieve optimal delivery of wealth management solutions on their own without the necessary support. Integrated systems and processes will also ultimately place limits on the autonomy of advisors with respect to portfolio discipline, sales methodology and methods and scale of remuneration.

¹ An area of focus will be the development of the advisor role, industry structure, the development of new distribution models and the advisor/portfolio manager/planner relationships within this evolution. All relationship structures are characterised by natural physical rules, the extent to which these natural physical rules influence development is dependent on transparency, regulation, knowledge and competition within the market place.

- In an integrated process driven solution, advisors perform an investment planning and client relationship management function: they are no longer responsible for security selection, asset allocation or strategy and hence there is no longer any leeway for transaction based remuneration.
 - We need to be clear about the way the industry is going to move, the importance of economies of scale and of increasing sophistication in wealth management solutions.
 - In physical terms (natural relationship between integrated components of efficient wealth management systems) financial planning can no longer be separated from investment management: asset and liability management are integrated. This impacts regulation and the terms and format of product and services distribution. There will be challenges and change for all areas of the industry.
- ✚ Costs (high cost active versus low cost passive investment) and the ability of the current product and service distribution system to adapt to the impact of high costs (high operational and distribution costs) and the low probability that higher cost products will add value. How the industry reacts to costs and factors impacting those costs will affect the ability of product and service developers to innovate, compete and survive in a much more difficult market place.
- The probability of an actively managed fund with a 3% MER plus transaction and commission costs beating a low cost index traded fund over long periods of time is extremely low and not worth the odds. One could conceivably invest in an equity only ETF strategy and easily out perform in terms of lower risk and higher return, even with systematic withdrawals, a high cost balanced risk managed investment solution.
 - In more competitive environment companies will need to clearly understand the reasons for high costs in the industry (valid or otherwise), which components are contributing most to these costs, how companies could improve their returns on capital, increase service standards and access the market place more efficiently.
 - Large areas of the market place may not be capable of being efficiently serviced under current frameworks: 80% or more of the market place is occupied by the smaller investor, where the costs of personalised service outweigh the benefits. This does not mean that this 80% is not a viable business opportunity², just that the current method of servicing this area may be inefficient.
 - High costs are compatible with a transaction based industry: transaction returns are independent of process (they do not need an integrated asset and liability management process to make them viable). While transaction based systems may be inefficient in terms of delivering productivity improvements to total wealth management processes, they present a barrier to change if an industry relies on such a framework to distribute products and

² The costs of servicing the bottom 80% is most likely a reason why the overall costs are high for all investors: innovation in delivery of service and products to this segment may improve value for money across all market segments.

services. Firms implementing process driven change will need to look at this issue carefully, as will future perspectives in the current series.

- ✚ The death of the hype driven transaction model? There are not many asset classes that can currently be sold on past performance; there are no longer any hot sectors that generate sufficient transaction commission, and many downside risk management products have failed to live up to all their promises³.
 - Companies going to have to be very careful to deliver products and solutions that investors want, that are consistent and transparent in their claims and that live up to their claims?
 - A transaction based model depends on new products whereas a structural approach borne of business and service and asset and liability integration does not.
 - Care will need to be taken to ensure products can be incorporated into integrated process driven platforms: these platforms will effectively perform the same role that complex products were originally intended to perform and what we know today as complex products may well cease to exist.
- ✚ Income and capital security needs to be managed, as does the expectations generated with respect to those products that are intended to manage them. This also means that where there is a divergence between expectations and outcomes, companies incur liabilities that impact brand: while markets and economies moved inexorably onward and upward from the late 1970s and early 1980s risk to brand and credibility were relatively low.
- ✚ Companies that wish to develop a retirement income planning brand and credibility will need to minimise risks of divergence between expectations and outcome and this is likely to require a change in culture, systems, processes and attitudes.

The issues raised in this section of the perspective are focussed on those most obviously illuminated by the crisis. These issues will be developed and analysed in depth in subsequent analysis and developed along with an analysis and perspective of the possible future direction, structural issues and challenges facing the industry.

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³ Note the protection events on PPNs that were often buried deep in prospectuses.