THE INVESTMENT FUNDS INSTITUTE OF CANADA | L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA

Advice and the Modest Investor: A Canadian Perspective

Helping Canadians build wealth to sustain them in retirement is a core activity of the investment funds industry and one that delivers significant public policy benefits in the form of increased financial independence, greater retirement readiness, and improved financial literacy.

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The Investment Funds Institute of Canada is the voice of Canada's investment funds industry. IFIC brings together 150 organizations, including fund managers and distributors, to foster a strong, stable investment sector where investors can realize their financial goals. The organization is proud to have served Canada's mutual funds industry and its investors for more than 50 years.

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Introduction

For most investors, access to advice has a measurable influence on their long-term success.

When people first begin to invest, they often have only limited funds to work with, and they generally require significant upfront advice before they are motivated to start building a portfolio. Advice helps build the knowledge and confidence new investors need to become informed investors capable of making sound decisions. Well-trained advisors work hard to instill life-long savings habits through the regular knowledge transfer that is the hallmark of the advisor-client relationship.

Research shows that Canadians who have a financial advisor accumulate much greater investment wealth over time than comparable investors who do not have an advisor. Advised investors are more disciplined about staying the course during uncertain economic times.

Canadians of almost all financial means, including modest and early stage investors, can access advice at a reasonable cost through the many purchase options currently available in this country's well-regulated advice market.

Investment funds, for example, offer opportunities for retail investors with modest savings to access professionally-managed and diverse investments through a variety of channels that may include easy and affordable access to investment advice.

It is a great credit to the country's investment funds industry and its financial regulators that Canada has fostered an environment where deep and viable advice markets can flourish, delivering advisory services to investors at all levels of wealth.

Who are Canada's 'Modest Investors'?

Investors with high levels of wealth can always find financial advisors to serve them. A unique feature of Canada's marketplace has been the growth of advice markets for those of more limited means – Canada's 'modest investors'. Advisors spend much more time than they are compensated for at the beginning of a client relationship by the promise of compensation on a growing base of assets in future years.

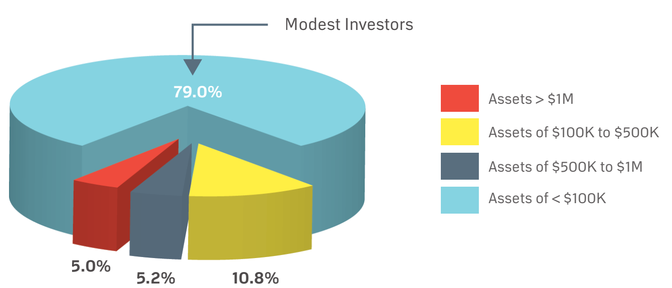
In this article, we define 'modest investors' to be households with financial instruments and investments held for the purpose of accumulating and preserving wealth, of less than $100,000.[1]

The data in Figure 1, taken from Investor Economics' *Household Balance Sheet 2017*, shows that in 2016, about 79% of Canadian households with financial assets were in this category.[2] This represents a substantial segment of the Canadian population. According to client research conducted by the Mutual Fund Dealers Association (MFDA), there are 7.4 million modest investor households in the MFDA channel alone.[3]

Today's modest investors have the potential to become tomorrow's wealth-holders. Their financial well-being in future years depends strongly on their ability to adopt sound savings and investment practices early on, and to continue to make good investment decisions along the way.

Figure 1

79 per cent of Canadian Households with Investment Assets are Modest Investors



Source: Investor Economics, Household Balance Sheet, 2017. (2016 data)

[1] This definition is comprised of: short term assets including savings deposits, short-term paper, GICs, and short-term investment funds; and long term assets including fixed term, fixed income, funds, equities, and other discretionary financial assets. Investor Economics, *Household Balance Sheet 2017.* (data to end of 2016)

[2] Households with $0 in financial wealth are not included in the Investor Economics database. Households with between $0 and $50K make up 74.7% of the sample.

[3] *MFDA Bulletin #0721–C: MFDA Client Research Report*

Most of us start out as Modest Investors

A great number of Canada's modest investors are "early stage" investors who are just beginning to save.

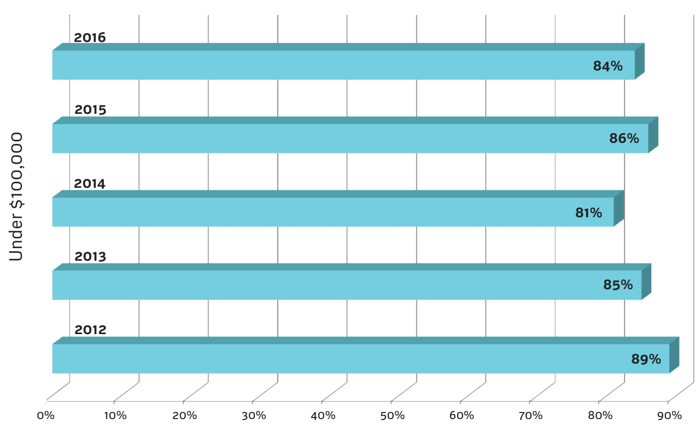
In a nationally representative sample of mutual fund investors conducted annually by Pollara Research, 84% of advised investors indicate that they held less than $100,000 in household savings and investments when they first started using an advisor (see Figure 2). Similarly high percentages have been reported in each of the 5 years Pollara has asked this question[4]. Significantly, over half (55%) started with less than $25,000.

Why should Canadian regulators be concerned about modest investors who have such relatively low levels of assets?

The answer is that a significant proportion of these investors are at an early stage of their investing lifetimes and, with advice, over time their assets can grow substantially to serve their lifelong needs. From the Pollara survey, more than half (55%) of the above respondents who began their advisory relationships with assets of less than $100,000 currently report investment assets exceeding $200,000.[5]

Figure 2

Percentage of Canadian mutual fund investors with less than $100,000 when they first seek advice



Source: Pollara, Canadian Investors' Perceptions of Mutual Funds and the Mutual Fund Industry, 2016

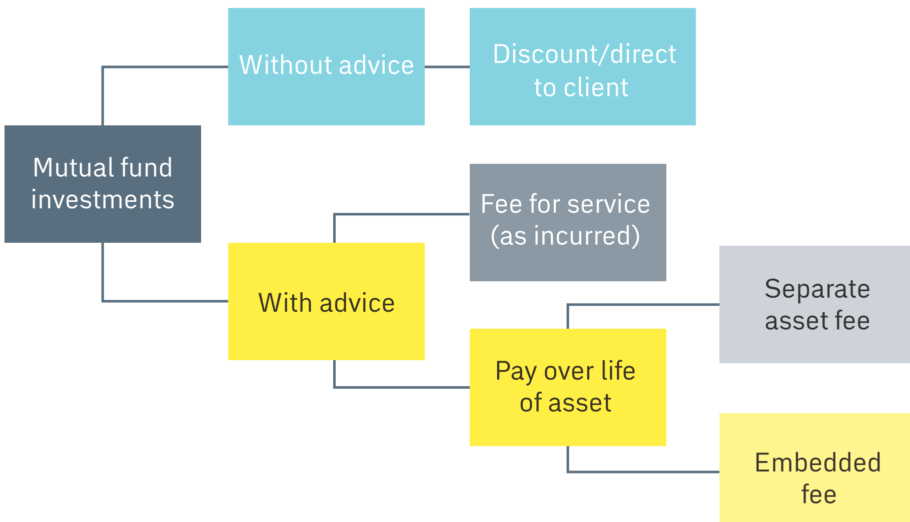
[4] Pollara, *Canadian Mutual Fund Investors' Perceptions of Mutual Funds and the Mutual Fund Industry*, 2016 (the question was not asked in 2017).
[5] Pollara, *Canadian Investors' Perceptions of Mutual Funds and the Mutual Fund Industry*, 2016 (using cross-tabulation data).

What are the current options when it comes to paying for financial advice?

Figure 3 below illustrates the options that exist in the Canadian market for purchasing mutual funds with and without advice.

Figure 3

Existing payment options in the Canadian mutual funds market



Eighty-five percent of mutual fund investors invest with an advisor – the lower path in Figure 3 above.[6]

There are good reasons why Canadian investors prefer to invest through an advisor. Clients gain a better understanding of their individual objectives, risk tolerance and how best to achieve their personal investment goals through the Know-Your-Client process that a client undergoes at the initial stage of an advisory relationship, through the development of a savings plan, and the monitoring and updating of that plan over time. Clients become more financially literate and less prone to behavioural biases in their investment decisions. These positive effects lead to higher wealth creation over time, as evidenced in the findings of research conducted by CIRANO.[7]

[6] Pollara, *Canadian Mutual Fund Investors' Perceptions of Mutual Funds and the Mutual Fund Industry*, 2017 p.21.

[7] *The Value of Financial Advice*, Annals of Economics and Finance16-1, 69{94 (2015). The authors concluded that their research provides: "… important insights on how the process of advised wealth creation actually works. In particular, the research paper provides new evidence that: shows that: i) having a financial advisor for at least four years has a positive and significant impact on financial assets after factoring out the impact of close to 50 socio-economic, demographic and attitudinal variables that also affect individual financial assets; ii) the positive effect of advice on wealth creation cannot be explained by asset performance alone: the greater savings discipline acquired through advice plays the major role." This research was updated with similar findings in the CIRANO publication, *The Gamma Factor and the Value of Financial Advice* (2016).

What are the current options when it comes to paying for financial advice?

The predominant means of paying for advice and dealer services in the Canadian mutual funds market is to pay over the life of the asset, based on an annual percentage of assets held – again, shown in the lower path of Figure 3. These payments can be structured as either separate asset-based fees or embedded fees.

In *separate asset-based fee accounts* – a growing segment of the market - the client pays the advisor's dealer directly for advisory services. The mutual funds held in these accounts are generally F-class funds whose MERs do not include fees for distribution. In order for the client to know the all-in costs of investing in these funds, the investor must add the funds' MERs and the separately charged fees paid to the dealer.

In *embedded fee accounts*, dealer and advisor services are paid for out of the fund as a percentage of fund assets. The distribution fee, sometimes known as a "trailer fee", is disclosed as part of the fund's management expense ratio (MER). The actual dollar amounts paid directly and indirectly to the dealer for its services are delivered to the investor in annual statements in accordance with Client Relationship Model – Phase 2 (CRM2) requirements.

How do Modest Investors prefer to pay for advice?

Given a choice, Canadians indicate a reluctance to pay directly for advice.

The Pollara 2017 Investor Survey reports that only 37% of mutual fund investors prefer to be charged a fee for ongoing advisory services directly by their advisor and that 53% prefer the convenience of paying their advisor through mutual fund fees, even with the knowledge that these fees reduce their investment returns. This effect varies by income level: those with lower incomes are less inclined to pay directly than those with higher incomes[8] . Research by the MFDA shows that modest investors have the greatest concentration of assets in embedded fee arrangements and that as household assets increase, they experience a shift to non-embedded funds.[9]

The Pollara survey also indicates that if consumers were required to pay a fee higher than the current fee embedded in their mutual fund, only 50% of those presently using an advisor would continue to do so (Figure 5)[11]. This latter point is significant since, as illustrated later in this report, fees for advice charged outside of a fund's MER tend to be higher than embedded fees, particularly for low-balance investors.

Figure 4

Investors' Preferences about Paying for Advice[10]

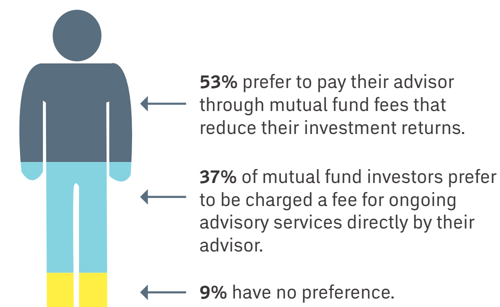
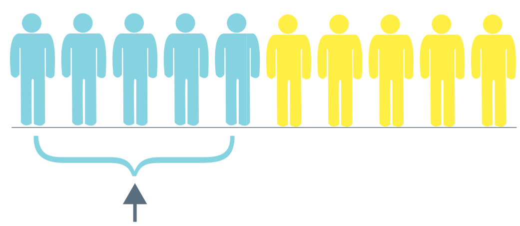


Figure 5

It is Important to Ensure that Investors Receive the Benefits that Advice Provides



[8] Pollara, *Canadian Mutual Fund Investors' Perceptions of Mutual Funds and the Mutual Fund Industry*, 2017.
[9] *MFDA Bulletin #0721–C: MFDA Client Research Report*
[10] 1% did not provide an answer, explaining why the total response equals 99%.
[11] Pollara Investor Survey, 2017.

How do Modest Investors prefer to pay for advice?

Affordable options for all investors must be preserved to ensure that as many as possible are able to build their savings effectively through the guidance and discipline that advice offers.

Internationally, U.K. research has shown that investors generally prefer not to pay financial advisors directly for financial advice, and this is particularly true for investors with smaller amounts to invest.

These findings were confirmed in the final report of the Financial Advice Markets Review (FAMR), a review prompted by a U.K. government concern that advice gaps for low-balance investors had grown since embedded compensation models were eliminated in 2012 as a result of the Retail Distribution Review (RDR). The final report of the FAMR, released March 14, 2016, found that less affluent investors are unable or unwilling to pay for comprehensive face-to-face advice. The report recommended a number of measures to make one-off or limited advice or guidance available to modest investors, with several recommendations focused on using technology and automated advice and product delivery models.

The value of choice for Modest Investors

In markets that have experienced a natural evolution away from embedded commissions or where embedded commissions have been eliminated through regulatory directive, there is evidence that modest investors pay more for, and generally have less access to, advice than they do in markets where embedded fee models exist.

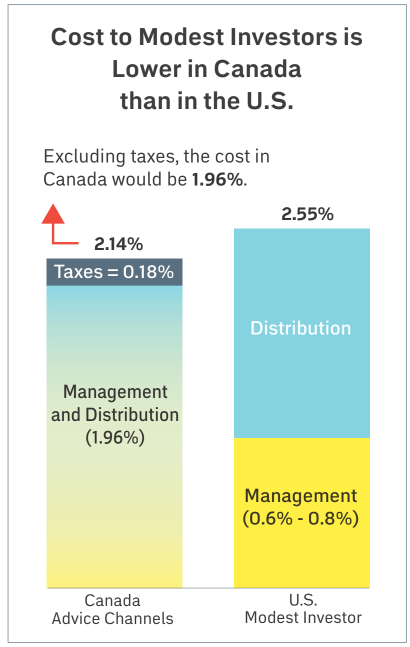
In the U.S., Strategic Insight reports that approximately 80% of advisor-sold funds use a fee-based model where advice is charged separately to the client. In this market, advice fees of up to 1.75% of assets are commonly charged to investors with assets of $100,000[12] as compared to an embedded cost in Canada averaging only 0.78% for distribution of long-term funds, regardless of the investor's level of assets.[13]

The result is that Canadian mutual fund investors, including modest investors, pay less than modest investors in the U.S. for comparable funds.

Looking overseas, Europe Economics reports that a move away from embedded commissions increased costs in the U.K.: "The evidence available does imply that adviser charges have increased post-RDR, at least for some consumers."[14]

Europe Economics also reports that fewer new advisory accounts are being opened for modest investors in the post-RDR world than pre-RDR: "GfK finds that there has been a decline in the proportion of adults who opened investments post-RDR. The decline has been most notable for those with pre-existing savings/investments in the £50,000-£99,999 segment –– the proportion of this group opening an investment in the year up to the date of the survey declined from around seven to five per cent. Those with between £20,000 and £49,999 in savings and investments also exhibited a decline in incidence".[15]

Figure 6



[12] *Monitoring Trends in Mutual Fund Cost of Ownership and Expense Ratios, A Canada-U.S. Perspective*, Investor Economics and Strategic Insight, May 2017, p. 17.
[13] *Mutual Fund MERs and Cost to Customer in Canada: Measurement, Trends and Changing Perspectives*, Investor Economics, September 2012, p.5.
[14] Europe Economics, *Retail Distribution Review Post Implementation Review*, December 16, 2014, p 67.
[15] Europe Economics, December 16, 2014, p. 13. (citing data from GfK NOP Ltd, Financial Research Survey (FRS)).

The value of choice for modest investors

The Financial Advice Market Review (FAMR) found that accessibility to advice has been reduced post-RDR and that quality personalized advice is primarily accessible and affordable only for the more affluent. The review also found that many consumers who would be willing to pay for advice were discouraged by higher prices.[16]

The MFDA's Client Research report concluded that a ban of embedded compensation would eliminate payment options and, "may result in advisors having to charge clients an upfront fee to cover the cost of their services. As mass market households are less likely to be able to afford direct pay arrangements and are less likely to be eligible for fee-based programs, they would be the most impacted by a ban of embedded compensation.[17]"

[16] *Financial Advice Market Review Final Report.* https://www.fca.org.uk/static/fca/documents/famr-final-report.pdf
[17] *MFDA Bulletin #0721–C: MFDA Client Research Report*

Why do Modest Investors need advice?

As noted above, approximately 85% of advised mutual fund owners in Canada were modest investors when they first started out. These investors benefit from advice in the same ways that all investors benefit:

- They begin and develop better savings disciplines;
- They accumulate greater savings over time, and
- They enjoy benefits that increase with the length of the advisory relationship – amounting to on average 1.7 times more assets after four-to-six years, 2.9 times after seven-fourteen years, and 3.9 times more assets after 15 years than comparable non-advised investors.[18]

If payment options for advice were to become more restricted, those with relatively few assets, comprising the mass market of Canadian investors, are at the greatest risk of becoming less financially independent over time, less prepared for retirement, less financially literate, and more prone to investment biases and self-inflicted capital losses characteristic of 'do-it-yourself' investing.[19]

[18] *The Gamma Factor and the Value of Financial Advice.* CIRANO (2016).

[19] *Financial Knowledge and Rationality of Canadian Investors,* Cécile Carpentier and Jean-Marc Suret, study prepared for Autorité des marchés financiers and the Ministère des finances du Québec. March 18, 2012

Conclusions

Most Canadians are modest investors, or have been at some point in their lifetimes. Up to 79% of Canadian households with financial assets may fall within this category today. Many are younger Canadians just beginning to save for future goals. Others are working Canadians with limited discretionary resources and financial knowledge who would like to invest for their family's future needs and their own retirements.

These Canadians are being well-served through a variety of branch and financial advice channels. Where mutual funds are involved, this is often through programs set up by advisors compensated by fees embedded in mutual fund pricing. A regulatory ban on embedded fees could result in fewer modest investors having access to advice. Wealthier investors would continue to have ample access, as they do today, through fee-based platforms, but modest investors currently being served through commission-based arrangements would find their access to advice more restricted and, likely, more costly.

If embedded fee models were to be eliminated from the Canadian market, some modest investors who currently work with advisors might respond by moving their investments to non-advice alternatives. Fewer new investors would be in a position to acquire one-on-one financial advice. This could severely limit the ability of new investors to grow their assets.

Under such a scenario, modest investors would be at greatest risk, among Canadian investors, of becoming less financially independent, less prepared for retirement, less financially literate and more prone to investment biases than they are today.

It is vitally important that policy makers continue to pursue policies that actively support and promote access to advice for all Canadians.

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