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Wealth Management and Executive Financial Planning

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Mr Bernie Ripoll MP
Federal Member for Oxley
Chair, Parliamentary Joint Committee on Corporations and Financial Services
PO Box 555
GOODNA QLD 4300

Dear Bernie,

Re: Financial Adviser Remuneration Models

It was a pleasure to meet with you on 8 May 2009 to discuss the role of the Parliamentary Joint Committee on Corporations and Financial Services which you Chair.

I have a particular interest in the Committee's review of remuneration structures used by financial advisers, as I have long believed that the models used by many advisers can drive behaviour that is inappropriate and not in the client's interests. In relation to the mis-selling of products, I strongly urge you to tackle the cause, i.e. invariably high commissions, not the effect.

Since Stewart Partners was established in 1998, we have always operated a fee for service model to ensure our clients have total transparency of their investment costs. Paradoxically, this best practice approach often penalises our firm when attracting new clients as they may believe our approach is more expensive than their current arrangements. However if we are able to do a full cost analysis for them – a task even we often find difficult to complete given the inherent lack of transparency in financial services – we typically find our approach significantly reduces their investment costs.

First, I would like to emphasise that for many advisers their behaviour must change to ensure they:

- Place client's interests first; and
- Deliver, without conflict, carefully considered advice on strategy, structure and implementation and provide ongoing professional counsel to clients.

Often advice may be to retire debt and develop long term savings programs in minimal fee environments. Furthermore, much time should be spent with clients in educating them and re-educating them not to make foolish mistakes when investing to ensure that they are compensated for the risks they take and to adequately diversify. This has nothing to do with 'selling product'.

Incidentally, I recall at our meeting your comments that "the area that really interests me is education". We consider education vitally important – it is not negotiable. We do not accept clients until they agree to the disciplined process we adopt – which often involves many hours of education including stress testing of investment outcomes and detailed personal risk profiling.

The following table provides a clear differentiation between a salesperson or facilitator, where remuneration is invariably driven by commission, and a true professional adviser who charges on a fee basis:

Facilitator	Adviser
Focuses on investments	Focuses on client needs, educates, develops policy and strategy
Picks stocks	Diversifies through asset allocation
Times Markets	Captures asset class returns
Focuses on Returns	Understands risk/return trade off
Chases Performance / Speculates	Maintains a disciplined investment approach
Offers a Suite of Products	Focuses on outcomes
Stimulates activity / turn-over	Provides wise counsel and coordination
Looks 'busy'	Informs clients of holistic options & solutions

In order to achieve these 'Adviser' outcomes for investors, I strongly urge your Government to encourage advisers to transition to the 'best advice' environment. In order to promote this transition, we recommend the Government make all professional advisory fees tax deductible.

In terms of separate licensing, consideration should be given to the segregation of a 'sales licence', with full transparency relating to costs in both % and $, and an 'adviser licence'. The former may be more applicable for insurance agents and the latter for professional fee charging advisers.

The costs for an investor typically fall into three categories which I outline and discuss below:

- **Adviser fee** – the receipt of commissions by advisers has an inherent conflict of interest that cannot be avoided or diminished to an extent whereby I believe this remuneration model will ever be acceptable. We only need to look at the examples of the 10% and 18% commissions paid by the opaque investment vehicles of Timbercorp and Great Southern Plantations respectively and the number of investors who ended up in these investments to see the resultant damage that commissions can inflict. I doubt that many advisers or accountants who recommended these products to their clients did sufficient due diligence on them to understand the inherent risks of these investments. If not for the high commissions being offered, these products would most likely have been shunned by many of these advisers.

  There is also little credibility to the argument that most people cannot afford to pay for investment advice and that commissions are the only option for these investors. The investment returns offered by products that pay adviser commissions will be inherently lower as the cost of the commission is recouped through higher Investment Cost Ratio (ICR) fees. So the net impact is the same – the investor either pays lower adviser fees and receives a lower investment return, or pays a higher adviser fee and receives a higher investment return. The second outcome is preferable as there is less inherent conflict of interest as to what products should be recommended to the client, thus increasing the chances of the investor receiving a higher long term return.

The best practice adviser remuneration model will always be fee for service. This may take the form of a fixed annual fee or a percentage of funds under advice. Whilst both options are far more credible than the commission model, the fixed fee model is more appropriate in certain circumstances.

Many advisers will find that a fee for service model is harder for prospective clients to accept compared to a commission model as the transparency can create initial alarm, especially for investors who have no clarity as to their current costs, which we believe should be segregated into investment cost ratio (ICR), adviser fee and custody/administration. We certainly encounter this situation regularly. However, it is the responsibility of the adviser to demonstrate to the client the value of their advice, whether it is a lower total cost to their current arrangements or the benefits of adopting a long term strategy and robust investment philosophy that shuns expensive managed funds.

Adopting a fee for service model has enabled Stewart Partners to navigate the Global Financial Crisis for our clients without any ruinous episodes from products like managed investment schemes or managed funds that have frozen redemptions. The only damage any of our clients have sustained is an exposure to Timbercorp, which was recommended by the client's former accountant, and which, due to its illiquid nature, regrettably we were unable to redeem when they became a client.

- **Custody & Administration** – for many investors, using a custodial wrap platform provides access to lower cost wholesale managed funds and administers their overall financial affairs.

  The evolution of wrap products has resulted in suppliers either paying rebates to advisers or advisory groups creating their own badged products with inbuilt fees that legislation does not require them to disclose to clients. Consequently, the true cost of custody accounts for clients is often opaque.

  We are endeavouring to move a small number of clients that we currently receive a rebate for onto custody pricing arrangements that pay no rebates, as we believe this improves transparency for our clients (though we still disclose all rebates to them and the rebate forms part of our adviser fee at present). Applying this approach across the industry will encourage wrap platform suppliers to continue to enhance their product offering to attract business from advisers, which ultimately improves the value proposition for investors.

- **Fund Manager ICR** – one of the primary reasons we recommend custody and administration wrap accounts to clients is that they provide access to wholesale managed funds, which charge significantly lower costs than retail managed funds.

  We recently reviewed around 50 prominent retail funds and found their average ICR was 1.91% pa. Given that our smaller clients with around $1 million of investable funds pay approximately 1.67% for strategic advice, wealth management, custody and administration and ICR fees, it's evident that retail managed funds can be a high cost for investors with inadequate benefits.

Unfortunately the lack of transparency in PDS documents often means investors don't know how much they are paying, or aren't aware of what is a reasonable ICR fee. As an example, a business acquaintance of mine recently asked 15 university graduates to review a PDS and accurately calculate the annual product fees. Not one of the graduates could do it.

High costs can materially impact the growth of a portfolio over time. For example, a net annual fee of 1% to manage $1,000 invested in the All Ordinaries Index between January 1980 and December 2008 achieved a portfolio value of $17,444 after 29 years. An annual fee of 2% reduced this amount to $12,995, and at 3% fee the portfolio value was only $9,652.

We strongly believe that the benefit of using lower cost tax managed funds is not only their outperformance relative to other funds, but if structured appropriately, they provide extensive diversification and ameliorate risk.

It should also be compulsory for all fund managers to publish after tax performance. This performance is more relevant to investors than gross returns as the after tax return is what the investor actually receives. At present, we understand that only three fund managers publish after tax returns. The reason only three managers provide this information is clear.

Traditional fund managers who employ very active management techniques turnover their portfolios regularly, often resulting in high tax and transaction costs. This means there is often a large variance between their published gross returns and the after tax returns their clients receive. Even as a long standing member of the industry, Stewart Partners is unable to obtain after tax return data from the major fund managers.

I encourage the Committee to persevere with ensuring the financial services industry eschews the commission remuneration model in favour of a fee for service model to ensure that all investors receive impartial and transparent advice.

Furthermore, this will be achieved more quickly if the Government ensures that the fee charged to clients for advice is tax deductible, as per our recommendation, thus encouraging clients to seek professional advice.

The common themes in the adviser issues I've identified above are lack of transparency and inappropriate advice most probably driven through the desire to earn obscenely high commissions. Ensuring investors receive transparent information and the separate licensing for a) salespeople who derive commissions, i.e. the life insurance sector and b) professional fee based advisers, should be what the committee focuses on rather than significant structural reforms. Transparency will cause financial service providers to modify their own behaviour resulting in the successful firms attracting more clients.

I do not believe that it is necessary to separate the provision of financial advice into strategic advice and product advice in order to achieve this outcome.

Should you have any questions or would like to discuss this letter in further detail, please do not hesitate to contact me on (02) 9241 1400.

With kind regards,

Yours sincerely,

Nigel Stewart*
Chairman

* Nigel Stewart is a director of a number of companies including DFA Australia Limited. The comments expressed relate to only the views of Stewart Partners Pty Limited and not those of any associated entities.