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# Perspectives on the practice of financial advice in a challenging regulatory and business environment

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We live in times of disintermediation and consumer empowerment (consumerism). We are the real bosses who determine which industries thrive or descend into obscurity. We acknowledge information is asymmetrically distributed among providers and customers – product and service providers know much more about their business expertise than we do – therefore we want our regulators to ensure a fair playing field when we deal with product and service providers across all spheres of our daily lives.

Modern technology and communication facilities have played a tremendous role in facilitating the move towards disintermediation. In many instances we no longer need intermediary services when acquiring information and purchasing products. In theory and (sometimes) in practice we save transactional fees by dealing directly with suppliers, i.e. eliminating or shortcutting the classical distribution channel of supplier-wholesaler-retailer-consumer. Yet, there are some practical limitations how far we can go with disintermediation – typically complex processes and products with many possible alternatives require specialist knowledge to make meaningful interpretations and sound decisions.

Let us review the role of financial advice or more specifically, the need for financial advisors when making important financial decisions. Certainly, not all of us have the financial know-how or financial literacy at our disposal to make informed and sound financial decisions. Furthermore, typically hordes of financial products and solutions are available for a multitude of possible financial needs – for a novice it is really a complex and intimidating task to make a shortlist of possible solutions, let alone making a final choice among the many alternatives. Thus, it would be safe to assume that financial advice for most people should be necessary and available, but the question arises through which medium – financial advisors or alternative channels, like the mass communication media?

Today there are many sources of free “advice” (more correctly “information”) available. In fact, in that sense financial advice has become non-monetised, i.e. not really worth paying for since it is likely one will find such advice for free on the internet, radio, television and the print media. If you like, you even can customise your “advice” by putting forward your questions to financial experts sharing their knowledge, for example, on radio shows. These experts will exhibit their skill by offering you with swift solutions to whatever queries you would throw at them. Often these shows will actively market its worth by claiming the wonderful financial advice you will receive by keep tuning in.

While everyone would welcome accessibility to worthwhile sources of information it is important to keep a sober perspective and to highlight a number of issues that typically crops up with these sources of free financial advice.

Since 2004 the rendering of financial advice is regulated and governed under the FAIS Act. While it is important for any financial advisor to understand the onerous obligations they must fulfil under the Act, one must also understand which activities specifically are exempted and not governed by the Act. For example, financial advice rendered in the public domain (print media, internet sources, radio and television) are deemed <u>not</u> to be financial advice and as such do not fall under the ambit of the Act.

A practical consideration, for example, is that one cannot claim remedial actions when following irresponsible or wrongful advice from these sources – as such the Act only acknowledge such sources as “financial information” and not “financial advice”, despite the claims thereto that you might hear or read to the contrary.

Furthermore, one must bear in mind that these experts often sponsor airtime for particular shows which have a commercial motive in exchange for the opportunity to market their products and services to the public. Thus, the recommendations are not necessarily objective advice and might be biased in one direction or another. Also, particular persons or institutions featured regularly on shows are not invited purely on their expertise, but because they basically paid for their seat. Yet, the public may overlook this and tend to think because the expert said so, I must do the same or my financial advisor must concur!

A further issue arises when financial advice is “generalised”, i.e. statements like “for most people” this or that will work. The essence of valuable finance advice is that it is very specific or personalised, thus considering your very own specific circumstances (lifestyle, family structure, risk profile, etc.) and needs (insurance or risk planning, retirement planning, estate planning, etc.) The truth is that everybody’s financial needs and circumstances are different, thus careful analysis is typically required before recommendations can be made. Unfortunately such public domain sources of financial advice have not the capacity to analyse one's financial position in detail, hence it is unlikely such advice is workable or sustainable in the long run.

Thus, while these alternative sources of "financial advice" have grown in popularity, it cannot replace the need for human intervention and analysis, i.e. the need for financial advisors as a full-fledged profession.

A while ago a well-known financial journalist wrote in one of his weekly columns that he has never seen any research indicated that financial advisors were actually adding any material value to the financial wellbeing of their clients. The journalist acknowledged there are very good financial advisors in the industry, thus he is not condemning the profession, but the rotten apples certainly are spoiling the image and net contribution of the financial advice industry.

I have no idea how one will conduct such research objectively, because we all suffer to some degree from hindsight bias - we tend to think that the good outcome of a particular strategy was due to our own brilliance and foresight. A bad outcome, however, was due to bad luck (external circumstances) or poor advice from advisors. Nonetheless, I tend to think that such industry-wide research, if possible, would show that financial advisors *on average* do not contribute positively – probably akin to the notion that professional investment managers *on average* do not add any investment value above market returns.

Why would I say that? Well, only if you include all advisors, irrespective whom they work for and how they are compensated, in the study. In my opinion, the business environment in which the adviser operates, does matter a lot. I believe most financial advisors want only good outcomes for their clients and want to act in their clients' best interest (ethically), but because the way many advisors are remunerated and incentivised, it will give rise to conflict of interest issues. In many instances salesmanship is rewarded instead of stewardship.

A large contingent of financial advisors are employed by financial institutions, such as insurance companies and banks, whose primary objective is not one of offering a philanthropic service to the public, but to maximise sales and profits, i.e. these "sales agents" (a more correct version) have production targets to meet. The potential drawdown of this structure is that strategies or actions that would have been in clients' best interest may play second fiddle to the profit and remuneration motives of the employer and employee.

To be sure, "conflict of interest" is not a unique phenomenon in the financial advice industry; across many industries and professions one will probably identify similar tendencies or practices. Over the past number of years FAIS legislation has been propped up to stamp out potential areas that may give rise to conflict of interest, yet it will always remain a contentious issue because of the advisor-reward structure.

If a study somewhere in the future would support my thesis of "*on average* financial advisors make no positive contribution to the financial well-being of their clients" would that negate the need for a financial advisor? Certainly not, because you as the client have the right to choose not an "average advisor"!

What you as the client ultimately need is the basic knowledge and skill to identify good advisors or advisors that at least operate in a business environment conducive to sound financial advice. Often, business operations owned by external or parental shareholders are focussed primarily on short-term profits without due concern for what is in the client's best interest in the long run.

Good advisors place their clients' interest first and are primarily interested in nurturing long-term business relationships. They act and think independently and serve no boss or exterior motives and are not required to meet certain production targets.

Obviously, such advisors are in business, well for business reasons! Their services do not come cheaply as they tend to be highly educated, and effectively exclude the mass market (less affluent market) from their business scope. Their business models are often fee-based (a fee charged for assets under advice), as opposed to commissions (sales). Typically they are more focussed on wealth management than acting as insurance brokers and run a professional office rather than acting as travelling salespersons.

The financial advice industry has undergone a major transformation in recent years and will continue to transform as legislators and regulators impose and enforce consumer-friendly behaviour and accountability for advice.

The traditional insurance broker model will find it increasingly difficult to survive as commission structures may be diluted further while consumers increasingly may purchase products directly from product providers, although it is not always a cheaper or better route. Not surprisingly, some advisors may decide to leave the industry, and like what happened elsewhere in the world, the total number of financial advisors in the industry will dwindle.

The business model of the professional financial advisor, however, are perhaps more resilient to a tightening legislative financial advice environment since they are focussed on building strong, long-standing client relationships, as opposed to selling products to many people as possible. In effect, their clients are paying them management fees and the advisor is not dependent or pressurised on selling products to make a living.

I expect the financial advice industry to become increasingly professionalised, which is a positive development, but at the same time the cost of advice will become much more direct and expensive than before. For example, in the past clients did not pay any out-of-pocket fees to an adviser when preparing quotes and was only paid commissions once a quote was accepted. If not, no charges applied. In a new business model clients will have to pay an out-of-pocket fee, whether any business was concluded or not, which in some cases may amount to more fees than the previous model of commissions only.

Perhaps an unintended consequence of increased, stringent regulation (and less lucrative commission structures) in the rendering of financial advice is that an increasing number of people will not be serviced by financial advisors or, alternatively, they will not be able to afford them. Ironically, they are the ones that need financial advice the most, but I guess that is the price the public will pay for greater transparency and fairness in the business of financial advice.