Brent Sheather's RESEARCH

Private Asset Management Ltd

January 2025

Brent Sheather is a Financial Advice Provider and a personal finance and investments writer.

FINANCIAL ADVICE AND INVESTOR BELIEFS: Part 2

Last week we started a three part series which introduced a recent paper entitled "Financial Advice and Investor Beliefs" (the SS paper), recently published by the National Bureau of Economic Research and looked at the extent to which active and passive strategy options are presented to retail investors by financial advisors. Part 1 highlighted how ostensibly passive etfs are frequently employed to execute a highly active approach. Today we will consider the active/passive advice dimension locally: Whilst the SS paper assumes the pitch from a financial advisor will advocate either a passive or active approach from what I see in NZ most advisors seem to include a mix of both strategies ranging from a core allocation to passive with some active funds and individual stocks to, at the other end of the spectrum, 10 or so favourite stocks in each of NZ, Australia and international together with a couple of niche etfs and a few active funds. Very few advisors seem to be either 100% passive or 100% active in terms of their instrument choice but using the strict, and obviously correct, definition from the Journal of Beta Investment Strategies that "only the theoretical market portfolio is a purely passive catch" the vast majority of advisors in NZ would be defined as embracing a highly active strategy. The overriding message to clients is "our research department has identified these stocks/sectors as having the potential to outperform" or " invest as per your ESG principles, outperform and save the world " so definitely advocating an active approach. Whilst most advisory firms publicly shun market timing strategies, in practice this approach is a fundamental component of many advice propositions. An advisor who recommends individual stocks as opposed to broad based funds will invariably, in quarterly reviews, encourage clients to "sell this company and buy this one" on the basis of price performance and/or valuation. Additionally, and as commented on by the FMA in their recent DIMS review, most retail advisory groups, when detailing their asset allocation limits have extremely wide permitted allocations to each asset class, thereby enabling potentially high levels of turnover. An excerpt from that report reads as follows: "*Our 2022 survey found that 13% of DIMS providers have asset allocation limits with ranges of 0-100% of the overall portfolio, which is not a limit at all. While such wide discretion is permitted there is a risk that managers may abuse this and seek to time their investment in markets, rather than adhere to a long term allocation strategy. Attempting to time markets can lead to overtrading (and therefore increase costs).*"

As an aside the report seemingly contradicted that latter statement when commenting on strategic asset allocation dynamics "*Investors' long term objectives and outcomes can be supported by portfolios optimized to evolving conditions*".

Next up let's have a look at some examples of actual "private wealth solutions" prepared for retail investors. The equity component of one portfolio I saw recently, managed by a large financial advisory organization, illustrates this overall active approach:

- NZ Equities – 15 individual stocks (100%)

- Australian Equities – 14 individual stocks (86%) and 2 etfs (14%)
- International Equities – individual stocks (37%), active funds (30%), etfs (33%)

Whilst the portfolio contained some passive etfs it had no exposure to the sort of broad based global equity etf that actually represents a truly passive approach, or the closest thing thereto if you're a purist. Indeed most of the passive funds employed were concentrated in niche areas including cyber security and smart grid infrastructure so, whilst the portfolio contained a passive component, it was clearly managed with a very active overlay.

Another portfolio proposal I was asked to review, also originated by a heavy hitter in the retail advisory scene, apparently in charge of $20bn of client funds, followed a similar highly "active" approach as follows:

- NZ Equities – 10 individual stocks (100%)
- Australian Equities – 13 individual stocks (100%).
- International Equities – 23 individual stocks, 5 active funds, 2 etfs (the plan didn't disclose the split of the assets between direct equities and funds.)

A cynic might describe the portfolio construction methodologies outlined above as shunning diversification and best practice and instead being a function of what the research department recently recommended, which active managers presented to the advisor team last week and obviously also reflects the [misplaced] confidence, lack of experience, investment banking obligations and biases of the individual advisor. These two portfolios, representative of the investment strategies of two financial advisory groups with a combined $50bn of retail clients funds under management, highlight the extent of the deviation from the "market portfolio" typically implicit in investment plans in NZ. Of further concern is the fact that much of these assets are managed under a discretionary investment management service (DIMS). Just last month the Financial Markets Authority reviewed the DIMS sector and seems to have completely ignored the implications of a highly active approach in terms of returns, risk and costs.

It is worthwhile speculating as to why the financial advisory sector embraces an active approach so vigorously. Three reasons come to mind:

- Firstly, the more complicated one makes investing look like the easier it is to justify one's fees. The more fees you generate the better the car your drive, the suits you wear, and the more confident you feel.
- The more things you recommend a client own the more potential there is to make changes and thereby generate fees and look busy.
- As this column outlined a few weeks back many investors, and certainly most financial advisors, are into investing not just to make money but also to have fun. As Jason Zweig and Matt Levine argued owning three index funds and never making any trades ain't much fun. Financial advisors can "have fun" not just by investing their own money – they can do it by taking speculative positions with clients money and trading lots. Things go up, things go down, the phones ring, it's fun. With the advent of DIMS the client doesn't need to be involved, which means one doesn't have to waste time explaining the rationale for changes.

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.