Brent Sheather's

RESEARCH

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VALUE FOR MONEY AND FINANCIAL ADVICE (PART 3)

In the last two columns on this topic we covered the service dimension of value for money in the financial advice area based on research from The Lang Cat (TLC). However TLC didn't consider the cost of financial advice and the essence of value for money, once you have provided what clients want, is delivering it at a reasonable price. What's reasonable? One way of discerning that is to look at the average fees of the big players with the rationale being that "if they have accumulated lots of funds under management from investors, they must be delivering value for money". That is obviously a problematic definition given the asymmetry of information issues, tendency of the financial industry to obfuscate and, of course the difficulty for many investors of actually knowing what fees they are paying. Running with the definition of a reasonable price as outlined above I summarise my estimates of the fee numbers for three very large local advisory firms in the table below:

ADVISOR AND FUND MANAGEMENT FEES (%PA)				
	Advisor Fees	Fund Management Fees	Platform/FX & Other Fees	Total Fees
Firm A	1.10%	0.30%*	.20%*	1.60%*
Firm B	1.20%	0.50%*	0.20%*	1.90%*
Firm C	0.80%	0.99%	N/A	1.79%
*Estimated				

We will consider whether these fees represent value for money using three different benchmarks: relative to independent experts' forecasts of prospective returns, relative to the extra return one could reasonably expect from a balanced portfolio over and above leaving the money in the bank and lastly, vis a vis what institutional investors like the NZ Super Fund pay. It makes sense to look at total fees because clients rely on the advisor to choose the investments for them and this is obviously an issue for vertically integrated organisations.

First off, we need to acknowledge that the fees in the table above relate to an entire portfolio so, to make a valid comparison, we will assume an average risk portfolio of 40% in bonds, 60% in equities, with the bonds split 50% NZ and global and all of the equities offshore. On that basis, future bond returns are reasonably easy to estimate given current yields and on that basis we will assume 4.5% for investment grade securities. For global equities, I have used recent research by Aswath Damodaran who reckons US equities are priced to return about 8.5% pa. With the US stockmarket representing more than 70% of the world stockmarket we will assume 8.5% for global equities too. So from a 40/60 portfolio forecast return is 6.9% pa, pre-tax, pre-fees. On that basis the average 1.8% pa fee represents 26% of total returns. That's the impact on nominal returns but real returns are more important so if we look at the impact of the fee on real returns, assuming inflation of 2.5% pa, the fee appropriates about 41% of real returns which is a massive hit.

Another, arguably more insightful, perspective can be derived by comparing the cost of enlisting the assistance of an investment advisor with the extra return from a balanced portfolio over and above leaving the money in the bank. A retired individual could today simply put their nest-egg in the bank and earn

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4.3% for five years. So it is an interesting exercise to compare the cost of investing with the excess return from a balanced portfolio, above and beyond having the money in the bank. On this basis the 6.9% return pre-tax, pre-fees is just 2.6% above the bank deposit rate. So the average fee of around 1.8% appropriates about 70% of that excess return. Obviously fees at this level are a major headwind for performance. The extra return from equities above bonds is known as the equity risk premium and most independent estimates of the equity risk premium ie the extent to which equities will out-perform bonds in the long run, are between 3.5% and 4.5% (Damodaran estimated the ERP for US equities at 4% pa as at 30/11/2024). So given Firm C has a fee on their global equity fund of greater than 120bps and a portfolio management fee of 80bps they are effectively appropriating over half of the ERP, and that's for a 100% equities portfolio. Someone in the FT once described fees at this level as providing return free risk.

Our last benchmark against which to assess whether the costs typically incurred by retail investors represent value for money is to compare those fees with what institutional investors deem acceptable. One of the biggest institutional investors in NZ is the NZ Super Fund and the fund incurred total investment expenses of 0.37% in 2024 however only .11% of this was fees paid to fund managers. – the rest was made up of employee costs, legal, financial, tax and data and technology etc expenses. So on a like for like basis the .11% is a more reasonable benchmark than the .37% headline cost. That 11 basis point charge is just a fraction of the 1.8% pa fee typical of the three big players in the table above.

The table also reveals some interesting dynamics as regards how the gravy train is apportioned between the advisor and the fund manager: Firm C is a vertically integrated business combining both fund management and advisory services so with the fund managers in charge it's entirely predictable that they would receive a bigger share of the fee pie by compelling their advisors to recommend their own high cost funds. At the other end of the spectrum Firms A & B are run by financial advisors/stock brokers so their inclination is to maximise the fee they receive and at the same time minimise fund management fees so as to keep overall charges competitive. There are various ways of doing this but the most obvious is to use low cost ETF's and direct investment in individual stocks and bonds but the obvious downside of the latter approach is that it frequently compromises diversity and greatly increases risk. With financial advisors needing to keep costs low but at the same time reluctant to reduce their own fees its no surprise that in the USA and UK some of the most vocal advocates of low cost passive funds are at the same time hitting their clients with an advisory fee of 1-1.5%.

To conclude this series we will look again at an interesting paper which estimated the impact of fees on retirement income and inheritances (See NBR story – Quantifying Asset Management Fees' Effect On Retiree Income), ie the decumulation phase. The paper, by James Mahaney of Mavericus Retirement Services in New Jersey, estimates that every 1% in fees "results in a 15.4% reduction in annual income and a 23.4% reduction in inheritance amounts". How many residual beneficiaries of family trusts would consider fee levels that potentially reduce their inheritance by 42% as being fair?

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