Brent Sheather's
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UNDERSTANDING FAIRNESS IN FINANCIAL SERVICES, OR NOT?: Part 2 "WHEN FAIR IS FOUL"

Last week we noted that the FMA had recently published a paper on fairness in financial services and the conclusion of that report was that "consumers have a remarkably consistent understanding of what constitutes fairness in financial services". We then looked at the key factors that people consider when assessing whether they have been treated fairly or not. Today's article however presents evidence that, in respect of the investment management component of financial services, most people don't have much of a clue as to whether they have been treated fairly or not.

Obviously, in order to make a judgment as to whether they are being treated fairly an individual needs to understand what's going on. We can infer the degree of ignorance by looking at the academic research on disclosure. Why disclosure? Because disclosure relates to information and as a paper by Peter Cartwright of Nottingham University pointed out some time ago "central to an examination of unfairness in the context of financial regulation is the topic of information. One of the obvious causes of unfairness is where consumers lack information. In a perfect market all players have perfect information about the nature and value of commodities traded. In reality many markets, including those for financial services, fall far short of this ideal. Consumers in particular are likely to know less than would be necessary for them to make informed choices. They are in a position of information asymmetry in relation to providers of financial services." There's so many examples of information asymmetry in the retail financial services sector, it's hard to know where to start, but here's an example that crossed my desk last week: a family trust had been with a financial advisor for more than 10 years and their lawyer asked us to review their portfolio. The fee structure was disclosed in their quarterly reports at an over the top 2.7%pa but because the elderly individual's portfolio had an 80% weighting in shares and shares had done well one of the trustees with an accounting degree didn't see an issue. This person didn't know that 2.7% was about 2-3x the industry average fee, that shares have benefited from becoming more expensive in terms of valuation over that period and that an 80% weighting in risky assets wasn't appropriate for someone with limited wealth and a relatively short investment horizon. Disclosure is meant to even the playing field and it is the go-to tool for the FMA but it obviously didn't work in this case and all the academic research suggests that not only does it not work but it also has adverse side effects. Studies of disclosure suggest that it's only useful to experts in the field of finance, ie people who know what is going on, and this raises the possibility that what is deemed fair by a non-expert could be considered unfair by an expert. In the FMA survey whilst the perceptions of fairness were consistent if, as is likely, they reflect a non-expert sample, an expert might consider the conclusions in respect of the more complex issues as being consistently wrong.

In a paper entitled "The Dirt on Coming Clean: The Perverse Effects of Disclosing Conflicts of Interest", the authors, Professors DM Cain, G Loewenstein and D Moore of Carnegie Mellon University, argued that *"for disclosure to be effective, the recipient of advice must* *understand how the conflict of interest has influenced the advisor and must be able to correct for that biasing influence. In many important situations, however, this understanding and ability may be woefully lacking". The authors also note that "there is at least suggestive evidence that people tend to be naturally trusting and credulous toward their own advisors".* People tend to know that advisors might be conflicted but very few imagine that their own advisors advice would be affected by a conflict of interest.

In another paper, "Restoring Rational Choice: The Challenge of Consumer Financial Regulation", Harvard Economics Professor John Y Campbell, argues that disclosure has severe limitations if consumers are too financially ignorant to understand them. Secondly he notes financial services providers often neutralise the effects of disclosure by highlighting other information that distracts consumers. This column has already noted the inclination of fund managers charging high fees to frequently overestimate forecast returns so as to make their fees look less onerous. The tendency of fund managers to focus on ethical investing also offers the benefit of distracting investors from the fee issue. Campbell is of the view that whilst disclosure and education are important they cannot be the whole solution and legislation is required to restore the choices that consumers would make if they were rational and well-informed. He quotes Professor Richard Eli who has written about the unethical nature and destructive effects of competition within markets with poorly informed consumers. Professor Eli argued that these sort of problems need to be addressed in order to preserve political support for a broadly based free market system and he notes that the emergence of behavioural economics has opened the eyes of academics to financial behaviours that were not carefully examined before and to evidence that many households, particularly those with low income, low wealth and poor education, are not up to the challenges of managing their financial affairs. He believes that regulation is required to correct the mistakes that these sort of people make and its obvious from the disasters that are regularly reported in the media that many people in NZ make these sort of mistakes. He is particularly dismissive of disclosure and improved financial literacy as antidotes to the problems that many households make in engaging with the financial sector and argues that these solutions alone are unlikely to be sufficient because of the breadth and advanced nature of the knowledge needed to navigate modern financial systems.

Retail investors' understanding of fairness issues should, in theory anyway, be improved through the use of a financial advisor but the reverse is more often the case. Most obviously if the advisor is part of a vertically integrated organisation he or she is unlikely to risk their employment by telling a client that the fees they are paying are too high. This issue also extends to ostensibly independent advisors who have a relationship with a KiwiSaver provider who pays them trail fees. Secondly, any meaningful discourse on the subject of fund management fees could also throw an unsympathetic light on the financial advisor's own fee structures so it's far safer to steer discussions towards ESG related topics or ask how the grandchildren are doing.

Back in Part 1 we noted that the most important determinant of whether people feel like they have been treated fairly by the financial services sector is known as Distributive Fairness. This accounts for 61% of perceptions of fairness and it relates to how the pie is shared amongst the provider and the client. But the size of prospective investment pies are a bit like the definition of "fair" - uncertain and subject to all manner of influences including conflicts of interests. Complicating matters further the actual dimensions of the pie may not become obvious until 10 years or more after visiting the pie shop. For example, if you expected that your portfolio would grow at 10% pa real, after tax and fees like Armstrong Jones famously told clients many years ago you might think, if you weren't an expert, that a 2% pa fee to Armstrong Jones was fair, that your advisor deserved her 5% initial fee and the free trips to exotic locations. Having said that your view might have changed a few years later when the AJ's property trust you owned fell in value by 90%. Similarly, if you compared your managed share portfolio's return with bank deposit rates you might think 3% in fees was a good deal. This is exactly why so many financial advisors engage in benchmark abuse. The NZX got into the game as well sometime ago when it compared the return on shares with that of residential property but "forgot" to include rentals in its calculation of the latter return. On the basis of that analysis it declared shares the clear winner. The reason benchmark abuse is an area that finance graduates flock to is because, as per Distributive Fairness, if you can show that people will derive a fair deal, after fees, they will be happy to pay them.

But in NZ the reality is that all this discussion of fair is academic as there is a Get Out of Jail Free card available by way of disclosure in that " if you disclose anything goes". Unfair is made fair by disclosing the fact you are going to be unfair. This is the essence of the disclosure regime in NZ. Where investment managers and financial advisers get into trouble is not by being unfair it is by not disclosing that they are going to be unfair.

In two weeks time we will cast a critical eye over the FMA survey questions including looking at what actually drives perceptions of fairness as outlined by the FSRF.

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