Financial industry needs more transparency on fees

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Two investors in the same mutual fund can receive drastically different value even though they are paying exactly the same fees.

One client will get incredible service and comprehensive financial planning. The other will get a confirmation of their purchase and little more.

Industry participants are well aware of this discrepancy in how clients are treated because the industry’s dominant fee structure encourages it. With most mutual funds, the cost of managing the fund as well as the cost of providing financial advice are lumped together. Investors normally don’t see what portion of the fee goes to rewarding their adviser for providing financial advice. As a result, clients have no way of knowing if their adviser is providing fair value.

Consumer advocates favour an unbundling of costs, so that you can see exactly what you pay for the fund itself and what you pay on top of that for financial advice. In theory, if an investor can see the cost breakdown, he or she might make different choices regarding both products and advisers.

At the moment, fees can easily escape a client’s eyes. Mutual fund returns are reported on an after-fee basis – a fund that earns 12 per cent and charges an annual expense of 2 per cent will report a 10-per-cent return.

A 2-per-cent levy sounds small, but consider that a $10,000 investment that earns 6 per cent per year before fees would be worth just under $43,000 after 25 years; after paying an annual 2 per cent fee, however, the result would be just under $26,000. You can’t eliminate fees, but you certainly see the merits of reducing them.

Perhaps even more important is having a clearer picture of what the fees are and what you are getting in exchange for them.

One alternative to the embedded fee model is known as the fee-based model. For investors holding only mutual funds or exchange-traded funds, the cost of the advice is clearly indicated, but the cost of the product may still be embedded. The overall cost may not be any different than under the current system, but there is more transparency.

One benefit: Fees become more negotiable. If a client doesn’t want financial advice, he or she can dicker for a lower advisory fee.
Regulators are debating if the embedded cost of advice should be eliminated from investment funds in all circumstances. That means that in the future, everyone using a financial adviser would see a clear and separate charge for advice.

But are financial consumers ready for pricing transparency?

One association of financial advisers, Advocis, argues that many consumers will forgo seeking financial advice if they see the cost of that advice.

On top of that, it’s natural to prefer the simplicity of a single all-in price. Globe and Mail columnist Rob Carrick has a Facebook community page for readers interested in personal finance (www.facebook.com/robcarrickfinance). Last week he posted a picture of a concert ticket that was $55 with a $7 service charge on top of that. He asked if people preferred the transparency, or would prefer to just see the $62 all-in price. The vast majority of responses indicated they wanted the all-in price. They preferred to have the service charge embedded.

On the surface, it would seem that maybe Advocis has a point after all.

But the two situations aren’t comparable. With a concert ticket, we want the all-in price so we can figure out how much money is leaving our bank accounts and see how alternatives stack up. We don’t want to see an itemized list of fees and expenses that we can do nothing about except gripe. But if we can get a better seat for the same price, we’ll choose that every single time. So we want an all-in figure that can make the comparison as easy as possible.

Financial advice is different. Embedded fees that cover both the product and the advice make it difficult to understand how much we are paying for each. By unbundling the fees and adding transparency, we can make more informed choices.

If lobbyists feel that consumers wouldn’t be able to reconcile the value of advice with its cost, perhaps that’s because in some cases they would be right. Some advisers may not be providing as much value as others. Others, however, might be a bargain. By unbundling fees, we would make it easier for the best advisers to shine.