The Moral Case
(and thus practical case)
For Embedded Compensation In Mutual Funds

One individual's response to CSA Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commissions

David McGruer
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The contents and opinions expressed in this submission are my own. In no way should they be construed to be those of any individuals, businesses, associations or organizations I am affiliated with. Any inconsistencies or errors are mine and mine alone. I'm just a guy writing this without compensation and without the hundreds of millions of annual budgets spent by regulators. I write in the faint but still real hope that one day such arguments will no longer be needed because a society based on reason will have developed.

Along the way the reader will find several short comments that are in bold face with a line above and below. These are not excerpts from the text but rather are side commentary on the subject being discussed, designed to prompt further thought outside the main line of thinking. I hope they are not too distracting and that readers find them interesting and valuable. I have bold faced some other portions that I believe will help readers identify key statements and refer back to them more readily.

TABLE OF CONTENTS

Introduction **3**

1 - What is our standard of the good? **3**
- An advisor’s value proposition 4
- Free to choose 6
- The 5% per year embedded service fee! 6
- The fully moral system of financial advice 7

2 - What is the full and proper context? **7**
- What is the equivalent gain in the rate of return for advised investors? 8
- The true public good 9
- 36,000 extra annual transactions per advisor 10

3 - How should expert information be used? **11**
- The Brondesbury Report 12
- The Cumming Report 12
- Where are the high-service fee funds? 13
- A more comprehensive study of the determinants of fund flows 13
- I drank radioactive Fukushima orange juice 14

4. More to think about **14**
- The abuse-use fallacy 15
- The false-attribution fallacy 15
- The no-threshold fallacy 15

5 - The Big Picture **16**
- That which is not seen 16
- The moral high ground 17

The last word **17**

Introduction

After reading CSA Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commissions I felt dismayed at the great harm that would be inflicted upon Canadians if this initiative was implemented and disappointed that securities regulators, who are charged above all with *protecting* Canadian investors, would be the ones *infringing their rights*, in direct opposition to the fundamental mandate given to them by the elected representatives of the people.

I expect the CSA will receive other professional-quality submissions (Advocis, IFIC, fund companies, etc.) that address the numerous questions posed in the Consultation in great detail and demonstrate how factual technical, economic and practical information contradicts the default position the CSA has taken in proposing a ban on embedded compensation. With their far greater resources, I cannot duplicate the quality of their work and instead have chosen to focus on the most important area of discussion - the area avoided at all costs by the CSA and unfortunately by almost all submission writers - the subject of morality.

I intend to demonstrate the morality of embedded compensation in mutual funds by critiquing the CSA Consultation Paper from five critical perspectives.

1. I will examine the CSA's assumptions about what is the proper standard of the good. On this it is very important to be very clear and explicit.
2. I will consider whether the CSA places ethical issues in their full context in order to gain a full understanding of the meaning and impacts of a ban on embedded commissions. I will carefully look at a few of the the clear positives and supposed negatives of embedded commissions.
3. I will discuss how information provided by experts should be used properly. I will examine both content and method of research reports that have been used to justify the CSA position on embedded compensation.
4. I will examine a few of the fallacies used to make the case the CSA seems determined to support.
5. I will summarize the big picture.

1 - What is our standard of the good?

Is the very popular use of embedded compensation in mutual funds and other investment products a fundamentally moral choice or an immoral choice? To answer this question, we need to be clear on our standard of value—our metric of good and bad—in investment regulatory issues. I find that the CSA position that embedded compensation in mutual funds should be banned is fundamentally a moral argument and one that is wholly incorrect. This response will demonstrate why this is so and provide a fully moral alternative position the CSA should take on this question and all similar ones.

The CSA paper refers to embedded compensation as "a compensation model with inherent conflicts of interest", with the emphasis on conflict of interest clearly indicating the CSA sees this as a moral/ethical

problem. The online legal dictionary defines a conflict of interest as "*the situation in which a public official or fiduciary who, contrary to the obligation and absolute duty to act for the benefit of the public or a designated individual, exploits the relationship for personal benefit, typically pecuniary.*" http://legal-dictionary.thefreedictionary.com

The key terms used in this definition are "*act for the benefit of*" and "*exploits..for personal benefit*." I believe it is safe to assume that a financial advisor's highest purpose is to act for the benefit of the client. As the CIRANO study ("*advised savers received net median returns that were about 3% points higher than non-advised participants*") and others demonstrate, advised clients are currently far, far better off in the long run than non-advised clients, so it is clear advisors are already broadly acting for the benefit of clients and the benefit is large and robust. The question prompted by the CSA paper then might be whether the advisor is acting in the interest of the client while exploiting the relationship at the same time? For "exploit" to be applicable, we need to look at what this term means, and Wikipedia says it is "*to take advantage of something (a person, situation, etc.) for one's own end, especially unethically or unjustifiably*." The word exploit would thus not apply to situations where there is an economic exchange of value for mutual benefit where the terms of the exchange are clear to both participants. Such exchanges are by definition just, not unjust, and win-win. Under a political system that properly protects individual rights (the moral meaning of justice) almost all economic activity is of this type since fraud is illegal and is prosecuted and punished.

An advisor's value proposition

Now let's examine the moral position of a financial advisor who offers the following value proposition to prospective clients.

- The advisor's functions are (a) setting and quantifying a goal, creating a plan, which, at historical returns, would realize the goal, and funding the plan with an appropriate portfolio (about twenty percent of his value proposition); and (b), behavioural coaching at times of pronounced emotional stress, when the client is at greatest risk of making The Big Mistake of turning a temporary decline into an investment loss by selling investments during a decline (about eighty percent of his value proposition).

- The advisor does not charge for selection and timing because he cannot deliver these consistently - no one can - and because relative investment performance is totally irrelevant to long term, real life financial outcomes. Above all, *"outperformance" is not a financial goal*.

- The **advisor's fee is approximately one percent per year of assets under administration**. This covers the costs of the services provided to the advisor by the investment dealer, the costs of running the physical office location and - most importantly - the personal advice you receive from the advisor. This fee may be embedded in investment products like mutual funds or charged separately to the client's account, but the advisor finds the embedded option far more economical and believes it also fosters better client behaviours.

In this example the advisor is making a clear value proposal to the client and stating a clear amount of compensation, with alternative mechanisms for that compensation, one of which is embedded and the other billed to the client account. Note in this case that the management fee of a mutual fund the

advisor uses is public and always has been, is disclosed through multiple clear sources, the client knows exactly how he pays the advisor and has agreed to it regardless of the mechanism chosen. The advisor may well wish to use the embedded mechanism for its vastly superior economy and lower cost to the client, ease of use, resulting cleaner client statements, client behavioural benefits and other reasons - see more on this below. The client may disagree with either the amount or method of compensation and thus no exchange takes place and the client seeks another advisor to agree with his terms. Unless both client and advisor agree, no transaction takes place and both the client and the advisor's right to choose has been respected. As I said, this is the very definition of a win-win free market transaction.

Government-run schools have done a remarkably successful job of graduating financial illiterates who are uniquely un-prepared for the real world. What percentage of high school grads who get their first job are required to complete an income tax return without the the least clue about the nature, structure and reasoning behind the income tax system? Do they know anything about mortgages and debt, life and disability insurance, economics, finance, education funding, budgeting, investments, retirement planning, powers of attorney and estate planning? Into this breach steps the financial advisor, charged with overcoming the abject failure of the educational system to prepare students for real-world financial issues.

Now back to morality. Under a political system that protects the rights of its citizens, the economic exchange illustrated above is perfectly moral because it is voluntary - it is freely chosen by both parties involved. Now imagine a third party comes along, sees this arrangement, then states that the arrangement may produce sub-optimal results, there may be a conflict of interest and such an exchange of values should be banned by law. Whose opinion will determine what is optimal and whether there may be a conflict of interests? The two people actually involved in the agreement or someone who is unknown to those people and they will never even meet? Who will decide to forbid the two parties from coming to an agreement and by what means will the ban be enforced? What threats will be used to discourage such trades, what police force will take action against those who might agree with each other and trade anyways and what punishments will be forced upon those who dare to make such an agreement?

This is all to highlight the title of this section - the standard of the good when it comes to a compensation mechanism. Is the moral standard a) whatever a third party such as an agency of the government arbitrarily says it is; or b) what freely acting parties agree is a mutually beneficial transaction? I believe **the proper moral standard is the one that leads to maximum human flourishing, meaning it allows for the maximum use of individual reason, decision-making and choice in economic activity**. This does not mean that every choice will be optimal according to someone's scale, it means that it allows for maximum options to be available and the most opportunity for people to think and choose in the absence of coercion.

The vague, morally-charged statements like "embedded compensation is an outdated model" or "Canadian mutual fund fees are the highest in the world" are an attempt to put something over on you. Check their premises.

Free to choose

A system that uses force to limit or even impose a total ban on free choice to trade is by definition immoral, unethical and should be condemned by all members of a civilized society. Presently, about 85% of mutual fund assets are in funds using the embedded compensation model, making this **the most popular form of advisor compensation ever devised**, by far and the only form of compensation that provides affordable, accessible financial advice to middle and low income Canadians on a large scale. So why do those who pretend to speak for these Canadians hold a position so completely opposite to the self-evident preference of those same Canadians? Further, in The Gamma Factor and the Value of Financial Advice by Claude Montmarquette and Nathalie Viennot-Briot the researchers found that more than 85% of households with a financial advisor chose their advisor and were not approached by one. Here I must again emphasize the crucial element of individual consumer choice - from among the wide range of compensation models available on the market, the vast majority of consumers have chosen advisors using embedded compensation. Ask yourself - does anyone have the moral right to forbid the free choice of consumers and the advisors who serve them? Does a group of people have this right? A large group? A majority of voting citizens? Their government officials? I don't think so.

The 5% per year embedded service fee!

Advancing a proposition to its extreme logical conclusion is often helpful in illustrating its correctness. Let's take the example of embedded compensation to an extreme: imagine a mutual fund company set up funds that allowed the advisor to select any amount of service fee the advisor desired, and an advisor set up a business and offered his services onto the market for 5% of assets under management per year - a 5% embedded service fee!. The advisor will certainly have to try to make a case to prospective clients that his advice is worth the 5% but since a free market is a competitive one, it is highly likely all clients would choose from one of the many advisors willing to work for less than 5% per year - heck, the client can find an online discount brokerage to buy EFTs that have almost zero compensation in their structure. It is only by allowing for all such business models to be offered on the marketplace that clients can sift through the options and choose the model that meets their preference. Notice that there are zero, and never have been, any mutual fund companies that allow such an option within their funds. Why? Because the fund companies rationally understand that competitive pressures make this a non-viable choice in the eyes of consumers and that the value of their reputation would be severely harmed, if not destroyed if they did so. Thus, creating such a model would be irrational and non-economic. Preferred models come to dominate the market and other advisors see this and adapt accordingly. **This is exactly how markets work and how the price signal works to make markets the most moral and most efficient mechanism for value creation possible: competition to find clients who agree with the advisor drive pricing to optimal levels**. By optimal I don't mean zero or

5% or any specific number, I mean the levels chosen and ever-changing by freely acting people in their roles and consumers and producers of advice.

The fully moral system of financial advice

So what is the full moral system I promised to disclose at the start of this section? It is one where people who make it their business to assess investment and business practice standards evaluate investment products and financial advisors and stake their reputation, and thus business success, on the accuracy of their judgement. It is also one where the government vigorously prosecutes and punishes fraud in its various forms. For example, if a professional association grants a designation to an advisor and the advisor is found to be not living up to the standard, then the designation may be revoked and the advisor's reputation and business impaired. Such an association may have insurance that compensates clients in case of the illegal or incompetent work of a member advisor. An advisor may have insurance that protects clients in case of certain negative occurrences. Government has an objective and robust court system that investigates claims of fraud so clients know the legal system backs them and is reliable. This system would have presently unknown but no doubt numerous options provided to consumers. Above all, buyers of advice would be fully free to choose among the variety of business models offered by freely acting advisors and fund companies would be free to design whatever products are chosen by consumers and their advisors. **Everyone's rights would be protected and none would be violated, especially by agencies of the state that are charged with protecting them**.

2 - What is the full and proper context?

The option for embedded compensation is of tremendous value in increasing both the supply and demand for financial advice and thus for the creation of life-enhancing wealth in our society. The possibility of a minor potential conflict of interest is a small side effect in the production of this great good. The CSA paper only lightly acknowledges the great social value of financial advice but places great emphasis on the small potential side effect. This is like proposing to ban vaccines because studies prove there are some side effects that are in truth very minor for the vast majority of people while ignoring the fantastic value in enhancing the flourishing of human life.

First, consider the fact that comprehensive, well designed, carefully reported and groundbreaking studies such as The Gamma Factor and the Value of Financial Advice by Claude Montmarquette and Nathalie Viennot-Briot are given only brief attention in the CSA discussion paper. This study, as illustrated in Figure 1 on the next page, shows that:

> In 2014, the impact of having a financial advisor took effect as soon as four years: for comparable households, the one with a financial advisor gains 69% more value for its investment assets. The additional value reaches 290% for a household with an advisor for 15 years or more (3.9 times the value of assets of the equivalent non-advised household).

This is an enormous creation of value! *After* the fees paid to advisors and for whatever products were used, the long-term advised client has about *quadruple* the financial assets! Imagine the wealth of a country where everyone had a financial advisor - the wealth of the society, the advances in science, medicine, the arts, technology and culture that would be possible. It would be like advancing the progress of the society by decades, with benefits for all the members of society, especially those least able to care for themselves.

What is the equivalent gain in the rate of return for advised investors?

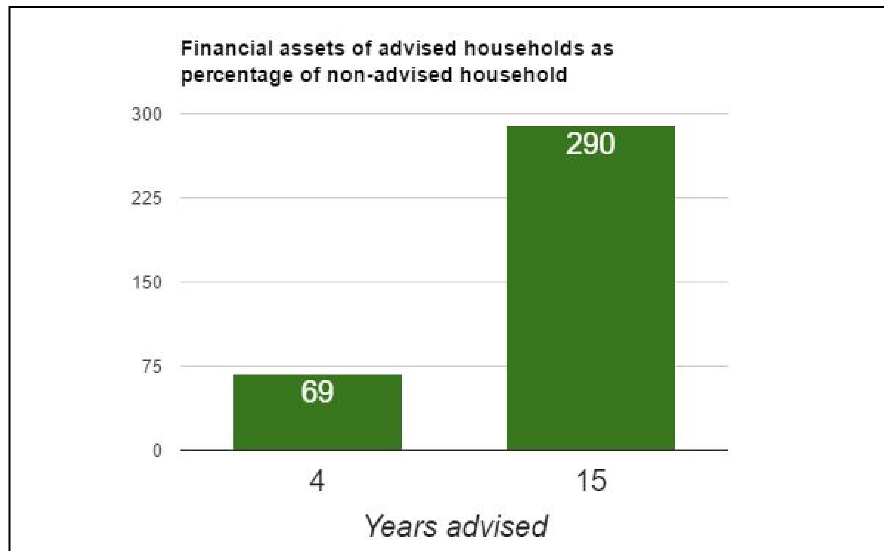
Although the authors of the study refer to other research showing an equivalent of 3% or more and do not show us a similar calculation based on their own data, it is possible to do this using the formula for the future value of money. Montmarquette & Viennot-Briot identified that after 15 years the advised households have accumulated 3.9 times the financial assets compared to non-advised households. Table 1 below shows how I have done this calculation and it finds the rate of return equivalent for advice to be 9.5%.

Table 1. Long term value of advice calculation		
Present Value	PV	100
Future Value	FV	390
Number of time periods	n	15
Rate of return	i	9.5%
FV=PV(1+i)^n		
i=((FV/PV)^1/n) -1		

Anyone who says "mutual fund service fees reduce client returns" is also saying "financial advice is a pure negative value for clients."

While one can argue the significance and method of doing such a calculation, I use it simply as one way of demonstrating that the value of financial advice is large- and again, note that this is calculated after all mutual fund fees and advisory fees have been deducted, so it is a net gain to the client. **I have long believed that my clients' gains from my advice are multiples of what they pay me and that I could never charge them anywhere near as much as the value I create**, and this study confirms my belief with careful measurements.

Figure 1. The financial assets of advised households versus non-advised households.



Source: The Gamma Factor and the Value of Financial Advice by Claude Montmarquette and Nathalie Viennot-Briot, 2016

The true public good

You see, just as energy is the industry that powers all other industries and civilization, finance is the sector that manages the allocation of capital to the best people and the best ideas that provide the very foundation of modern human life. Just as energy is the equivalent of calories in the human body and the power grid is like the blood vessels in our bodies, finance is the equivalent of the neural network that controls circulation. Good financial management makes all other human values more possible or even enables their creation in the first place. **The provision of good financial advice is of immeasurable value to society**. How do you measure the difference between a society that has vaccines and laser surgery and one that does not, one that has electronic communications and one that does not, one that has powerful machines to do work for us and one that does not. All of these and everything else is facilitated by finance - it is the communications and directions that connect the impossibly complex network of supply and demand for everything we produce and consume.

The fact is that financial advisors don't take inexpensive products and make them expensive, they take financially uneducated and emotion-driven prospective clients and turn them into better stewards of wealth who are better protected from financial disasters.

Consider the potential damage to society if the rights of citizens are violated by banning the embedded compensation option for financial products. Never mind the fact that the ban is immoral as shown above, what about the economic damage and the wealth destroyed or never created because the supply of financial advice was reduced and/or the demand for such advice was reduced. In fact, because multiple options are available for compensating advisors right now, we know that banning one

type of compensation can only lead to a **decrease in demand for advice**, since it is impossible that every single consumer who preferred embedded compensation before will switch over to un-bundled compensation. And what of the supply of advice? For many reasons, under a system of reduced choice there will be fewer advisors who will target a smaller number of wealthier clients, so the **supply of advice will decline**. What of the price of advice? When the most popular and economical form of compensation is banned, do you think the price of advice will go up or down? Right… **the price of advice** will go up..

Why don't regulators leap for joy to learn that advised investors have long term financial security that is hundreds of percent higher than those without advice and then do everything in their power to see that as many advisors as possible enter the business and as many investors as possible understand the tremendous value of advice? Maybe it's that doing so would mean their present budgets of hundreds of millions of dollars per year are poorly spent.

36,000 extra annual transactions per advisor

While there are similar concrete examples that can be used for several other harmful effects a ban on embedded compensation would have, I will leave that to others (and I refer the reader to the the excellent paper "A major setback for retirement savings: changing how financial advisers are compensated could hurt less-than-wealthy investors most" by Pierre Lortie, 2016) and use only one to illustrate the point clearly. Imagine, if you can, that you are a financial advisor with two hundred households in your practice (not at all unusual) and they have 1,000 accounts in total. For an account where there is a direct advisory fee charged to the account, there is a transaction for this fee shown on the client statement, thus in your practice there would be 1,000 additional transactions per month or 12,000 transaction per year. As they say in the infomercials… but wait! There's more! There is another line on the statements to show the HST on the fee! Thus, your practice now has 24,000 additional transactions per year. But hold on, wait for it… there's still more! How is the fee to be paid? There must be cash in the account to pay for it, so there could be another transaction to sell a tiny portion of an investment to pay for the fee and tax - that's up to 36,000 transactions per year!! Starting to get the picture?

The actual financial advice reality: abundant, affordable, accessible advice with embedded compensation enables both client and advisor to focus more time on improving lives instead of administering payments and taxes.

Oh, and the average household would then have up to 5 x 12 x 3 = 180 transactions per year on their statements just to administer the payment for advice and the associated HST. Do you think this might cloud their ability to interpret the much smaller number of transactions that were actually recommended by their advisor? Do you think the client might perceive that with such a high number of fee and tax transactions there should be consequently more investment transactions, even though once an asset mix and a portfolio are in place, research (see the work of Barber and Odean among others) clearly

indicates that nothing is virtually always the *right* thing to do? But nothing is also the absolutely *hardest* thing to do and without a caring, empathetic and tough-loving advisor to keep clients from doing something, the plan is highly likely to be blown up. Do you think an extra 36,000 transactions on statements will occur and that the cost of these transaction is nil? **Will costs to the advisor, the dealer and the client go up or down with 36,000 more transactions per year?**

Now how does this compare to the embedded compensation via a mutual fund service fee? In this case the mutual fund company calculates the total assets per advisor at the fund company and sends one payment to the dealer per month, or twelve per year. Let's see… 12 vs 36,000, which is more economical, easier to administer, less expensive for the client, leaves statements looking cleaner as they show transactions related to recommendations instead of administration, easily enables clients to see bottom line results after the fund company, dealer and advisor have all been paid? Could it be that the compensation model requiring 12,000 times more transactions to administer is a bit less rational in most cases?

Embedded mutual fund service fees may cause a fund to underperform a similar one that has no such fees, res ipsa loquitur, but we know for certain the clients who pay those fees are far, far better off for having the advice paid for by those fees.

But never mind rationality, practicality and economics - **what about the specific morality of embedded service fees?** The CSA claims their existence creates an intractable, irreducible conflict of interest. Is this true? Do studies really show this? Can they? The last section will examine this more closely.

3 - How should expert information be used?

While the CSA paper makes reference to a number of academic studies, two of them are given special prominence and appear to have been assigned much higher meaning than the rest: the studies known in the industry as the Cumming Report and the Brondesbury Report, which were in fact commissioned and whose parameters were specified and limited by the CSA. I will examine these in their proper context to illustrate the proper role of expert academic research in the process of formulating public policy. Before doing so, it must be stressed that the CSA specifically **prohibited the authors of both studies from considering the value of advice in their report**, thus zooming in on the potential consequences of small potential side-effect factors while deliberately avoiding any focus on the consideration of the greatest factor of all in the determinants of client success: the presence of advice.

Instead of comparing the current embedded fee environment to the one where consumer choices are eliminated and costs are higher, anti-fee proponents compare it to a non-existent fee-free utopia where clients act the same with or without caring advice.

The Brondesbury Report

The Brondesbury Report conducted no new research and was only a literature review of one area of research. The authors provided clearly conflicting conclusions. On one hand they say "evidence on the impact of compensation **is** conclusive enough to justify the development of new compensation policies" while on the other hand they state:

- While removing commission lowers product cost, advisory fees may rise as a means of paying for the cost of service. There may also be new or increased administrative fees, higher costs on margin accounts and lower payments on cash balances.
- There is **no** conclusive evidence that investors will have greater after-fee investment returns with asset-based compensation instead of commission.

I find that when I read the Brondesbury report there is an attempt to insert an unwarranted conclusion that compensation policies should be changed, despite much stronger statements that any such change is likely to cause both expected and yet unknown harms. It is as if the authors wrestled with the visible evidence that advice is of tremendous value, that freedom of choice is important, that a ban on one type of compensation might well cause great harm, yet inserted a conclusion they thought was what the CSA wanted to hear and was paying for. In the CSA Consultation I find insufficient attention is paid to the harms stated in Brondesbury and undue strength is attributed to the apparent mandate to interfere with existing free market mechanisms.

The Cumming Report

The Cumming Report was different than Brondesbury in that its task was to conduct original research using a large database of Canadian mutual fund transactions over 2003-2014. Specifically, it was to "examine the relationship between risk-adjusted performance ("alpha") and future fund flows ("flow-performance slope"), and fund flows that are obtained regardless of past alpha ("flow-performance intercept"), and consider whether or not flow-performance intercept and slope are influenced by the fund fee structure."

To highlight my key criticism of how the some research such as the Cumming Report is being wrongly interpreted and misused, consider its oft-referenced conclusion: "Trailer fees increase new flows regardless of past performance. Generally, the greater the trailer fee, the greater the level of net flows that has no relationship to past performance. For example, a 1.5% trailer fee increases the average monthly flows by 0.3% of AUM each month regardless of past performance." Okay, so on the face of it this seems conclusive and seems to cry out for a ban on service fees, but is this a fair interpretation of the data and is the full context examined? Not at all. Even if the interpretation was correct it does not justify a ban on embedded compensation, as I will show later.

Consider just two aspects of the brief quote provided. First, it states that monthly flows are 0.3% of AUM higher in a fund that pays a 1.5% service fee. Okay, but **how significant is this**? We are talking about 3.6% per year of increased flow, so it would take twenty years for the fund to double its size

when compared to if it paid an average service fee instead of an elevated one. Twenty years - during which much would change in the fund, the fund company, the advisor, the dealer and the marketplace. It is extremely unlikely the elevated service fee would persist very long because market competition would be very likely to deal with it with no regulatory intervention.

Where are the high-service fee funds?

How can I justify this last statement? That leads me to the second aspect - the 1.5% service fee that is given as the example. Where are these funds that pay a service fee of 1.5% vs the industry standard 1% for equity funds? How big are these higher-fee funds and what percentage of the industry assets do they represent? I understand the number of funds paying a service fee over 1% is 10% of the number of funds in Canada, but obviously many or most of these pay less than 1.5% plus they are likely not large funds in terms of assets, so funds that pay 1.5% likely represent much less than 10% of industry assets. It is speculation on my part, but **I'd bet that less than 1% of fund industry assets pay 1.5% or more in service fees**. I have been an advisor since 1993 and I am not aware of nor have I used any large funds that pay over 1%, but I have seen a few small funds that paid 1.25%. If I saw a fund with otherwise highly desirable characteristics and did pay 1.5% I would recommend to the fund company to reduce the service fee to be in line with the competition if they hope to attract my business, because I don't want to be associated with a high compensation fund in order to protect the value of my reputation.

Connecting this with the finding from Cummings, and **we have a very small fraction of funds paying above average service fees and attracting a slightly higher inflow of assets**. In 2014 Investor Economics reported that "over the last three years, two out of the three years higher trail products have actually been in net outflows and last year for 2013 they were in net inflows, but as it turns out the funds that had the higher trails that did see the inflows also happened to be the better performing products." I conclude that overall, the issue of high service fee funds is a statistically small one and is certainly no justification for a nation-wide violation of rights likely to cause large scale and lasting financial damage to the country.

A more comprehensive study of the determinants of fund flows

Another Canadian study released in 2015 "Analysis of Factors Influencing Sales, Retention and Redemptions of Mutual Fund Units" conducted by Investor Economics examined mutual fund flows in their full context, not eliminating all other factors and focusing on one, but instead looking at all potential factors and isolating the most important ones. The study states:

> Our analysis has revealed that no single factor can satisfactorily explain the volume of mutual fund sales and redemptions into a specific fund at a given point of time. Rather, mutual fund flow activity reflects the interplay of a large number of factors. While no factor in isolation offers sufficient predictive value in terms of individual fund flows, three factors have been identified as significantly relevant to advancing the understanding of the volumes and the directionality of mutual fund sales and redemptions.

1. Macro-economic and demographic factors comprise a powerful backdrop to fund flow activity and can overpower all other factors.
2. Individual fund investment return characteristics, expressed both in absolute and relative terms, represent the single most valuable predictor of sales and redemptions at the individual fund level.
3. Preferred access to distribution, either via direct affiliation or strategic alliance.

The researchers went on to examine the influence of advisor compensation on fund flows and found "**The statistical relationship between trailer levels and net flow volumes is not significant**." Further, they "The importance advisors and clients assign to the funds' investment returns, however, supersedes the importance of the level of compensation in the sales process." Acknowledging the shifting preferences of consumers and advisors over time, they go on to conclude "Meanwhile, the shift to unbundled fee-based practice models and the diminishing reliance on the upfront sales commission payouts associated with deferred sales charge load sales in the intermediated advice channels, have continued to lessen the impact of embedded advisor compensation on fund flow activity."

It is the contrast between the Cumming Report and this last report by Investor Economics that is at the heart of my point about the proper use of expert research information. In order to properly use the results of academic research, one must be able to identify the knowledge foundations of the study (that is to say we must examine its underlying assumptions), its research methodology, the statistical analyses performed, the representation and significance of these statistics and the limits to the conclusions one may draw from them before even beginning to use them to form public policy. The CSA commissioned the Cumming Report and asked for a highly specific and delimited result, which they received. However, when a statistically significant result can be found it is not scientifically nor morally sufficient to proceed as if this is equivalent to an assessment of the magnitude and importance of the result.

I drank radioactive Fukushima orange juice

As one extreme illustration of this principle, the reader may recall the earthquake, tsunami and subsequent Fukushima nuclear reactor breach in 2011. Because radiation leaked into the Pacific Ocean, it was spread by currents across to the west coast of North and South America. Thus it is possible that the orange juice I drank at breakfast today that contains California oranges contains one or more radioactive atoms from Fukushima. With sensitive modern instruments we might measure this and declare outrage, however we would be ignoring the significance and magnitude of the measured fact. The full context would include considerations such as a) humans have evolved in a low radiation environment and appear to flourish in such an environment; and b) organic Canadian maple syrup may be more radioactive than the California orange juice that had us outraged.

Expert research information may provide us with factual measurements, but the value we assign to the facts is moral in nature and must be placed in the full context of human life and with the understanding that our goal is to maximize human flourishing.

4. More to think about

To fully understand the errors in thinking within the CSA discussion paper would take much more space, but I don't want to end without examining a few of the fallacious thinking methods employed in the paper.

The abuse-use fallacy

The first fallacy could be called the abuse-use fallacy and refers to the incorrect linking of something that exists that *could* be abused or *could* create a severe conflict of interest such as embedded compensation, and then drawing the conclusion that therefore it ought to be banned under threat of legal punishments such as seizure, fines, loss of livelihood or even prison. Seizure and prison (violence against the individual) is always the threat behind the surface threats, otherwise when an individual refuses to comply, the lawmaker has no power. Even if we were to stipulate that in some cases some advisors choose to recommend products merely because of higher embedded compensation, it is irrational to say that because something can be abused that it ought not to be used at all. The use-abuse fallacy can be used to attack anything you don't like: you can say that because some people drink too much that all alcohol should be banned or that because some people die in car accidents that cars should be banned. Individual cases of abuse do not prove something should be banned, it proves it should not be abused.

We live in a country where the government agencies are focused on making financial advice expensive and inaccessible to a large portion of the population.

The false-attribution fallacy

The second fallacy worth examining is the false-attribution fallacy, which usually follows a simple three part formula. First a story is told where an investor has lodged a complaint based on a claim such as he didn't get his money's worth from an investment that had embedded compensation, or he didn't know about the embedded compensation. The most dramatic case is one where the investor lost money on the investment while the advisor was being paid a service fee even as the investment declined in value. The horror! The blame is then laid on the existence of embedded compensation without exploring other alternative explanations such as the responsibility of the consumer to make rational and reasonable inquiries about the investment, the fact that just about any mutual fund will recover from every decline and go on to new highs if allowed time, or the possibility that the investor acted emotionally and sold the investment at a bad time despite the advisor's best recommendation. The truth is that every form of compensation can be abused yet this is no justification for a legal ban on all of them.

The no-threshold fallacy

Finally, consider the no-threshold fallacy which uses the fact that because a large amount of something can be a problem that any amount of the thing is bad, thus it ought to be banned under threat of legal force. Refer back to my example of the radiation from Fukushima as one example. Think about what regulators would have to complain about if embedded compensation was 25% lower than the average of today - would this be low enough for the CSA to conclude that it was not dangerous, unethical and thus ought to be banned? What if it was 50% lower? 75% lower? You can see that there is no objective threshold at which it can be morally justified to ban embedded compensation since there is an infinitely fine spectrum of possible compensation levels. All that could be done to establish a cutoff point is to make an arbitrary decision based on whim and emotion, not reasoning and based on correct morality.

The false-attribution fallacy and the no-threshold fallacy for a particularly dangerous combination in the hands of regulators. Because there will always be stories of investors who lost money on investments that had embedded compensation, regulators use these as evidence to support a complete ban on all investment products that have embedded compensation. All too often, there is a failure of regulators or politicians to use human flourishing and the social conditions required for it as the standard of the good.

The liberated human mind, not the behaviour coercing bureaucrat, is the root of progress.

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5 - The Big Picture

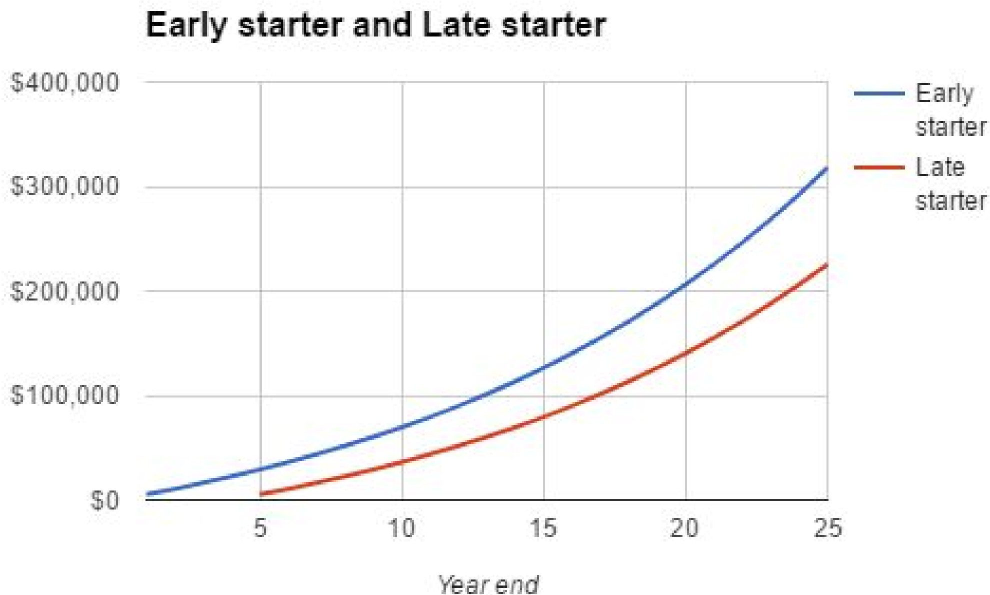
I hope the reader can now see that the CSA proposal to ban embedded compensation in mutual funds and other investment products:

1. fails to properly place compensation in its full context;
2. uses an incorrect standard of value, preventing the possibility of a conflict of interest, instead of that proper for a society dedicated to human flourishing;
3. makes incorrect use of expert research data that even deliberately avoids considering a full analysis and minimizes contradictory evidence;
4. uses several logical fallacies to make the case for a ban on embedded compensation seem strong or even irresistible when in fact there is no moral or practical justification at all for such a massive violation of the rights of investors, advisors, investment dealers and mutual fund companies.

That which is not seen

The harm that could be inflicted on Canadians by a ban on embedded compensation would be widespread and severe, reducing the future wealth of the country and holding back all forms of

progress. If a ban is implemented, Canadians will never be able to measure the wealth that was never created, the financial security that was impaired, the higher taxes required to sustain social programs, the health, education, and cultural benefits that never accrued. Just as investment returns compound on an exponential curve (see Figure 2 below) and the person who starts earlier shifts the curve upwards, so do regulatory actions that inhibit investors and advisors from making arrangements that are freely chosen and mutually beneficial create a society with lower demand for advice and a lower supply of advice, retarding the wealth curve of the whole society.



The moral high ground

Financial advisors, investment dealers and mutual fund companies should proudly stand up and proclaim their pride in the good they do, the value they create and the consumer relationships they have established. They need to realize that they occupy the moral high ground and state it clearly in their communications. I do not mean to imply that all advisors operate perfect practices - no such thing exists, or that all mutual fund companies and their products are excellent - this is an impossible standard in the most fiercely competitive market in existence. Rather, I assert that given the relatively free market that existed in the past, advisors and mutual fund companies accomplished incredible good and formed millions of voluntary arrangements with investors. Recent years have seen radical increases in regulation, rising compliance costs and the threat of much more of these.

Let it be said far and wide: in a market where government and its agencies protect individual rights, embedded compensation in mutual funds is a profoundly moral, extraordinarily economical and wildly popular form of financial advisor compensation that has led to unbelievably successful advisor-client results as measured by the accumulation of financial assets by advised investors.

The last word

If the advocates of banning embedded compensation in mutual funds had forced this on the industry 30 years ago, they would have prevented the creation of hundreds of billions of dollars of wealth in Canada and permanently damaged the lives of millions and millions of Canadians, yet we would have never known of this loss because the gains were never given a chance to accrue.