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Every day I read articles about the embedded commissions and the apparent problems they present to clients.

Todays article my Morningstar says the same thing. *“"While clients' best interests are served by holding lower-cost funds, asset managers have an incentive to promote higher-cost alternatives from which they generate more revenue from fees," the Morningstar submission states. "Asset managers use embedded commissions to give advisors incentive to favour higher-cost funds, creating a conflict of interest."* Sounds convincing, but not even close to the reality of the business.

I will admit that I use embedded fee funds for many of my clients. I do collect a fee from the funds for using them and my clients are well aware of this. But what really frustrates me is that the regulators perfect world that would be created by their rules and regulations is not even close to the reality of what is happening in this industry. The maximum trailing commission that I can receive on a fund is 1%, and that is pretty much the same across the board on any equity based, embedded fee fund. All those past articles about people selling funds with higher fees just because they got paid more was not backed up by facts. I only know of two fund companies that offered that in the past, and neither were large companies meaning they attracted very little business. In fact, many of us did not use them because we did not want to be accused of using them for the higher payout, even though they had many good funds (Sentry Funds is a good example)

But what has happened, and this is the “reality” aspect of these rules, is between the media and the regulators talking about embedded fees and the potential ban, many have now gone to the fee for service method. This is much better for clients we hear. Clients will have negotiating power we are told. That is exactly what is implied by the Morningstar article that you published today. REALLY? Better for clients has nothing to do with it. And regarding the article saying there is a benefit to the fund companies to promote these high cost funds, I am sure the fund companies take a small hit revenue wise when an “F” class fund is sold over an embedded fee “A” class fund, but it is usually only 15 to 20 basis points.

From my humble opinion of being in this industry for 38 years, this is really what has happened. The average fee for service in downtown Toronto is 1.45% we have been told, and I would assume the average account size in downtown Toronto is a lot larger than the average elsewhere. Across Canada the standard that most now charge seems to be 1.5% across all the assets held by the client. Of course article after article says that the benefit to the client of fee for service would be that these fees are negotiable but that does not seem to be happening. I have been told by a few people, including some that are working at banks, that there are clients that are paying upwards of 2% on accounts with millions in assets. So with that 1.5% fee for service, that would be a 50% increase over the maximum that I can receive on equity funds with embedded commissions, and a 200% increase on bond funds payout. That is quite the pay increase. Who in their right mind would not go that route if it is better for the client and we can double our pay? This is the reality. But there is more to it!

Why have index funds collected so much money? I know there is the argument that index funds have done better, and during rising markets they are tough to beat. But they are also a tough place to be when markets drop. As one colleague said to me, the thing about index funds is you get 100% of the up, but you also get 100% of the down. And we know how clients feel about the down. But are index funds being sold because they are better than managed funds, or is there more to the equation?

So how would someone like me increase my revenue but not hurt the client? Why not charge a 1.5% fee for service like everyone else seem to be doing. But what about the client? The client may have been paying a 2.5% MER on the embedded commission equity funds. So now that I charge 1.5% fee for service, I can use the F class funds. But, F class funds, without embedded fees, with a 1.5% fee for service gets more expensive that what they had before. I win but the client loses, and that is not right. And there you go… the answer to the index funds prominence in today’s world! The reality of today’s world is the index funds, with no management and low costs, have allowed the fee for service

brokers and planners to make more for themselves without increasing the costs for the clients. But what the clients have given up is professional management of their money. Is that a fair tradeoff? Similar over all costs but no management. Shouldn't the clients be compensated for giving up professional management for passive or no management?

This is all about making money, and not money for the client. I believe it is RBC that will not pay a broker on an account that does not generate a minimum of $5,000 in revenue. Do that math on that one. You certainly could not have a client with $400,000 to $500,000 in assets with a combination of embedded fee funds, stocks and bonds and actually get paid for that client. But have that client pay the 1.5% fee for service, throw in a bunch of index funds to keep the costs down, add in some stocks, bonds and other assets, and there you have it.

I still do not see anywhere where this is better for a client. Everyone pushes the cost aspect, such as the line in the Morningstar article shown above "*while clients best interests are served by holding lower cost funds*" they constantly ignore the fact that there is now an additional fee tacked on top of that low cost product. Costs have not gone down for clients in most cases, but revenues for the broker/planner/advisor have. But what the clients have lost in many cases is professional management, the exact thing that you would think Morningstar would be backing. All in all, regardless of all the regulators intentions, I believe the real losers in all of this will be the clients yet no one seems to see that. And when (not if) the markets pull back and we see a correction, suddenly those low cost index funds with the 100% participation in the drop might look to be quite expensive.

Jeff Rockel | Financial Advisor

HollisWealth | HollisWealth Advisory Services Inc.