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INVESTMENT PARTNERS

Ending the Era of Financial Services Mediocrity

Mediocrity *n: ordinariness as a consequence of being average and not outstanding.*

Over the past two decades, the global financial services community has enjoyed unprecedented growth provided by a nurturing regulatory environment, buoyant demographics, technological improvements, and monetary and fiscal stimulus. These ingredients have made the manufacturing and delivery of financial services affordable and accessible for ordinary consumers, creating a boom in the financial services industry, and energising the relatively embryonic financial planning sector.

Sadly, the low barriers to entry combined with the opportunities to earn super-normal incomes, have attracted many industry participants with distorted motives, those whose self-indulgence delivered a general sense of lethargy and staleness throughout the industry.

Many industry participants have long since forgotten about the expectations of the client, and have instead been motivated by greed and – more recently - self-preservation. For these folks it is difficult to ‘gift wrap’ the future of the industry in anything other than “more tough times ahead”.

To ensure all participants are adequately equipped for the future, it is useful to unbundle the process and examine the prospects ahead, looking from each perspective.

The Consumer’s Perspective

During the past few decades, consumers have been led to believe that it requires lots of time and money to achieve the significant ongoing expertise to manage their money. In return, the financial services industry has gained billions of dollars of commissions and fees while sheltering under this belief when, in reality, many of the experts who are employed to manage the consumer’s money have demonstrated a poor track record of doing so.

Sadly, consumers are reminded of the pitfalls of poor risk profiling, inadequate asset allocation and industry-vested interest each time they review their portfolio performances and their managed funds in the weekly league tables.

Even in today's markets, many consumers continue to be advised that "time in rather than timing" remains the best cure for their over-diversified myriad of managed funds that, at best, ride the waves of the market, and more often contains little reflection of risk budgeting or appropriate asset allocation.

In the current climate, many consumers blame the financial services industry for fuelling their greed, demonstrating poor transparency and failing to advise them of the true risk profiles of their portfolios.

Two decades of client greed and advisory laxity is now delivering a more laboured and uncertain industry recovery than the financial services community initially expected. Those consumers who were highly leveraged have endured a painful learning experience; the combination of unexpected risk, falling asset prices, and rising borrowing hurdles have forced them to become frugal in an effort to rebuild their wealth.

Despite the wise words of Sir John Templeton,

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“*’This time it’s different’ are the four most expensive words in the English language*”,

the reality is that tomorrow’s financial environment is being shaped by unknown forces, making it difficult for anyone to accurately forecast and prepare. The mountains of cash that are being channelled into banks signify consumers’ preferences to remain absent from both equity and money markets for the foreseeable future. Ironically, banks are scrambling to position themselves to prosper from this recent exposure to their customer’s wealth, only to discover that they no longer enjoy meaningful relationships.

Whilst some argue that blame can be shared between the financial services industry and consumers, few dispute a breakdown in confidence that has unfolded between the two parties.

Consumers view the industry as both the cause and consequence of the current calamity, and are awaiting proof of professionalism and transparency before placing their trust and respect in the hands of those who have failed, so far, to meet their expectations. Like fine china, the reputation of the industry has taken expense and time to acquire, and has been easily broken. This confidence will take time to be rebuilt, and will require unprecedented levels of clarity and communication between all parties. Until this occurs, the media (including the internet) has become the consumers’ new (albeit jaundiced) financial adviser, enticing them to convert long term investment strategies into shorter-term trading or preservation opportunities.

The Financial Adviser’s Perspective

It is regrettable that in an industry founded on relationships, financial advisers have been skilfully positioned to receive a disproportionately low percentage of the value chain income. Whilst all other ‘snouts in the trough’ purport to add

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immense value to the process of creating, managing and monitoring an investment portfolio, the financial adviser is often the only one that has actually met with the consumers.

Continued manipulation of the advisory community has occurred via a disturbingly high proportion of current financial advisers being lured to the industry with little or no relevant business or investment background. This has taken place at a time when product manufacturers have aggressively pursued vertical integration to purchase distribution, as a way of selling more of their products. This has had the dual effect of artificially distorting the perceived value of many advisory practices and the advisers within them, whilst diverting financial advisers away from client-centricity towards the structurally corrupt product-centricity.

Communications with clients have become less intimate and customised, as the industry coerces the community of fair-weather-advisers to ‘work on their business rather than in their business’. It’s almost as if the consumer has become an inconvenience to the financial adviser who is frantically attempting to convert two decades of relationships into a meaningful departure payment.

As portfolios deliver single digit returns over a prolonged period, the value proposition of each industry participant is being scrutinised, with consumers developing an intense distrust for those who are not able to clearly demonstrate why they should be paid. Evidence of this is already apparent – there are massive outflows from managed funds as consumers begin liberating their portfolios and taking back control.

Oddly, many financial advisers have failed to exploit the opportunity presented by current market turmoil to reassure consumers about their long term strategies, and revisit any reservations that they are experiencing. Many financial advisers continue to be deluded that their customer relationships are beyond impairment, and prefer operating under the status quo as opposed to adopting any meaningful communication.

Added to the stress that financial advisers are experiencing is the combination of:

- margin pressures;
- difficulties in exploiting purchased relationships; and
- growing shareholder demands

which are compelling many institutional accumulators to adopt aggressive direct accumulation and retention strategies.

Marginalised financial advisers who have failed to invest in their client relationships, and are oblivious to the long term strategies of other industry participants, will be the casualties of this approach.

This is the defining moment where informed industry participants will cement deep client trust – whilst others will watch 20 years of frivolous client encounters and purchased-databases of business erode before them.

All of this is occurring at a time where the ageing demographics of the financial advisory industry will make it difficult for many to break away from their hefty reliance on trail commissions, third party billing systems, soft commissions and veiled kickbacks. Many of the current participants appear overly motivated by their personal exit strategy from the business, and ways to appease prospective purchasers so as to receive the highest sale price.

The Solution?

For those financial advisers with industry longevity of more than 10 years, the solution is to begin the slow conversion to utilising risk profiling tools.

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They need to assemble relevant portfolios comprising of:

- index funds (for which they deserve no ongoing advisory fee); and
- alpha-focused investments with appropriately motivated investment personnel.

Most consumers have little interest in the individual components that make up their portfolios, preferring simple and predictable investment outcomes that match their expectations. This simplicity is contrary to the needs of the many financial services lemmings who continue to dice up portfolios into meaningless slices of historic styles and complexity to justify fees and demonstrate their poor understanding and inability to listen.

In the new world of financial services, the trusted adviser can derive revenue by providing ongoing personalised customer communication and appraisals, and by sourcing unique satellite investment opportunities – without cheating anybody or receiving kickbacks.

The method of receiving payment for providing these services is largely irrelevant as long as the financial adviser has power over the billing process, and the consumer is completely aware of the full amount and its derivation. Think of it as if the client owns the rights to the fees and commissions that are generated from their investments, which they knowingly pass on to their advisers in exchange for a useful ongoing service. As with most service professionals, the financial adviser may need to recognise the difficulties in selling their trusted relationships, and be prepared to walk away from their business when they are no longer capable or interested in adding value to their clients.

The Administrator's Perspective

During the era of double digit portfolio returns, little attention was paid by consumers to investment costs or the appropriateness of the investment vehicles/ structures used. In many cases, the recommendations made were myopic because of the focus on:

- the provision of a billing mechanism;
- improving client retention; and
- a perceived measureable exit strategy for an ageing financial advisory population.

In return for consumer apathy, the industry has been richly rewarded with continued inflows into these archaic investment vehicles, which have become little more than administrative and billing mechanisms to ensure that industry participants get remunerated. These structures have quickly pick pocketed consumers where they unwittingly pay a substantial premium over and above basic consolidated reporting alternatives, to support their financial adviser's back office.

Any real advantages to the consumer have long since been replaced by technology, and are often surplus to their basic requirements for an annualised portfolio summary and tax report. Unfortunately, platforms are positioned as an important component of the value chain, aiding in the fluid conversion of consumer's investments into industry wealth.

As administrators anticipate the margin pressures and technological challenges that await them, they are aggressively enticing financial services participants into pouring their clients' monies into these consolidated reporting systems – all at a time where technology provides consumers with cheaper (free!!!), faster, and easier solutions. These systems are now in the position of being the horse at a time when the tractor has arrived, and are providing a massive distraction for those in the advisory community who have succumbed to putting the interests of the industry ahead of their clients.

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The Manufacturer's Perspective

In the 1990s, the dramatic growth of managed funds prompted many large, existing financial institutions to reassess current asset accumulation strategies (at a time where traditional approaches to asset gathering were coming under competitive pressures). This saw a land-grab phenomenon in which banks and insurance companies outbid each other to secure their slice of the financial services manufacturing and distribution space. This also marked the beginning of the end for volume manufacturers as they endeavoured to unify their investment ambitions with their business ambitions.

Generally speaking, the investment management industry has demonstrated that it is not very good at what it says it does – and has been fortunate to have rising investment markets to ensure that bonuses are continually paid. The evidence against many active investment managers indicates that consumers who decide to pay an investment professional will end up worse off than if they had tracked the market itself. Whilst continued market deterioration will promote a growing interest in cheap alternatives such as Exchange Traded Funds (ETFs), the investment management community will attempt to protect their annuity incomes by promoting managed funds as the only appropriate investment structure.

The investment management industry is polarising into two distinct groups:

1. *Those who have Shareholders' Interests at Heart*

   Legacy relationships, convincing marketing, and advisor apathy continues to support this group's inappropriate investment management concepts to the detriment of the consumers.

2. *Those who Represent Stakeholders' Interests*

   This group is benefitting from a change in the demand/supply dynamics, as the smart money quickly chases proven investment talent or uniqueness, producing capacity constraints and soft-closes.

Industry manufacturers will continue to face rising levels of commoditisation as consumers insist on bespoke portfolios that adequately cater for their unique risk/return expectations.

The advisory community must distinguish between alpha and beta, and seek more appropriate investment structures to capture index-like returns. Alpha will become more challenging to source, as talent migrates to proprietary entities that don't have the marketing force of the bigger manufacturing entities.

In the absence of nimble research, financial advisers will need to develop effective methods to appraise innovative investment opportunities quickly and efficiently. But be cautious, as large institutional investors will continue to vindicate benchmark outperformance whilst still losing money for consumers, exposing the financial services industry as being out of touch.

The industry is already experiencing the harsh reality of the profit-focus and viability-assessment of investment manufacturer's businesses. Recently, a number of big-brand manufacturing 'stars of the early naughties' have hoisted the white flag by announcing dramatic changes to, or exiting from, historic asset gathering activities.

Star turnover will continue at an increasing rate as investment talent leaves these corporate incubators behind in favour of proprietary boutiques. Falling assets under management – due to market movements and investor migration – will impact on those manufacturers who are unable to secure new business, or only provide out-of-favour niche investment capabilities.

In an environment where shareholders are seeking robust returns, many parent companies will accelerate their evaluation of long term strategies and cull exposures to financial services entities that are unable to positively contribute to short term revenues. Casualties from this industry recalibration will include both large and small brands - with increased redundancies and the sudden appearance of ever-green products reinforcing their renewed attention to cost reduction and revenue diversity.

This places extraordinary challenges on advisory participants who find it easier to sidestep product evaluation by reverting to their default list of preferred managers – as the survival of their manufacturers will become a noteworthy point of difference for consumers who are appraising their advisers.

Survival in this environment will require the traditionally product-centric financial services industry to view the investment world through the eyes of the consumers. Product outcomes will need to be easy to explain and understand, with consumers eagerly chasing yield, or reverting to more traditional investment practices that deliver conservative and predictable outcomes. This will leave the recent breed of complexity-investment managers as obvious casualties.

Increased transparency and simplicity in product structure and fees will also be an essential ingredient in reviving consumer confidence in the industry.

The Wild Cards

Whilst these observations aren't exactly revolutionary, they are a sobering reminder of how quickly the fortunes of an industry can turn. Decisions by all participants in the financial services industry are already being made that are intended to preserve their function at the expense of others. Despite the anticipated number of industry victims over the next few years, there are a number of notable wildcards that add to the unpredictability of the financial services industry.

Politicians

By and large, politicians have previously avoided being outspoken against the financial services industry, due to a general environment of prosperity and good fortune. Consumer exposure to the severity of the market turmoil has now provided the politically ambitious with an excuse to display their empathy and interfere with the navigation of the industry.

- <u>On the negative</u>: political response to recent market forces may end up converting sizeable short term issues into monstrous longer term problems – without actually changing the fundamental behaviours of industry participants. It is difficult to confront the markets without creating distortions elsewhere during the process.

- <u>From a positive perspective</u>: politicians may embrace new legislation that reduces universal industry distortions and misguidance derived from the current influence of those providing Professional Indemnity cover. It is conceivable that consumers will be expected to take on more accountability in the management of their wealth, with easier recourse for those who have been misled or are victims of bad advice.

Industry Regulators

In the absence of any revolutionary consumer protection laws, regulators will be expected to respond to renewed political anxiety by imposing new layers of compliance and costs upon an already heavily burdened financial services industry. Whilst a few high-profile scalps will be paraded as a show of force by the regulators in the short term, the administration of additional conformity will soon prove beyond the resources of the enforcement agencies that will be unable to prevent the villains from continuing their activities. Whilst this is the inevitable pain that must be endured as payment for decades of complacency, it will have the impact of lifting the barriers of entry to a level that is only realistic for those participants with corporate support or high levels of personal currency.

Banks

Central bankers around the world continue to wring out the last drops of hope using monetary policy, with cash rates dropping like lead. Eventually, consumers will be motivated to emerge from their paradox of thrift as negligible bank returns bite into their lifestyles. This may well produce a whipsaw return to equity and property markets, albeit with a cautious return back to the waiting arms of the financial services industry.

Conclusion

Despite the past few years of financial services mediocrity, the essential ingredient of meeting expectations has remained unchanged: trust. The recent industry carnage has swung the trust-pendulum from an age of assumed fiduciary responsibility to an age of distrust. The recent Bernie Madoff scandal has demonstrated that even the most sophisticated investors were not immune from misplacing their trust in those with sound reputations, pedigree brands or industry longevity.

It will be no coincidence that those industry participants who invest heavily in maintaining the highest levels of trust and integrity will prosper during these uncertain times, whilst the institutions that they have vacated will dissolve in their ongoing quest for mediocrity.