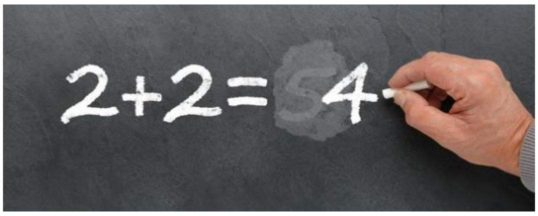
Two and Two are Still Four



George Burns once advised to look forward into the future, as that's where you'll spend most of your life. As we sit here in Lockdown, it's useful to reflect on where the local financial services industry will travel to next.

Let's start with the consumer – you know - the person who ultimately supports us all. In an environment where it's been easy to jump on, hang on, and enjoy the ride, investors have been tempted to self-drive, and / or avoid the industry through passive or limited-thought investment strategies. Up until most recently those investors who have paid for robust advice, have enjoyed a similar outcome to those who threw their savings at the index and enjoyed the ride. More recently the markets have savagely reminded us of Newton's logic that "what goes up must come down". This volatility has been noticeable in KiwiSaver, where members switched over $1 billion from higher risk funds to conservative options in March, changing their risk profiles and effectively crystallising any paper losses along the way. The virus and its consequences are leaving people both emotionally and financially fragile which will no doubt encourage them to seek professional guidance from the financial advice industry. If this truly is the end of the mother of all bull markets that was fuelled by the mother of all secular falls in interest rates it should also spell an aggressive decline in the reliance on indexing and tight market / peer relative risk controls as more investors appreciate the need for good old fashioned prudence and sound qualitative judgement.

What will be interesting is who in the advice industry will benefit from this rise in consumer inquiry and how they will be able to ensure that the relationship is mutually beneficial for everyone. According to the MBIE December 2016 "Report of the Small Business Development Group" the overall number of small businesses represented 97 percent of all businesses in New Zealand with the vast majority utilising the services of an Accountant as their trusted adviser. Mix this with the technological improvements in gathering and processing data with the exemptions provided by the Financial Advisers Act, and it appears natural for Accountants to solidify their position as the financial adviser for the self-employed community.

Other benefactors will undoubtedly continue to be those financial advisers who have a tangible value proposition which includes a developed transparent mechanism to demonstrate what clients are paying for. Conversely, those advisers who are reliant upon the "more you have, the more you pay" models, or charging healthy relationship-premiums in exchange for infrequent communication, mediocre portfolio performance, and annual reporting encounters will struggle to justify their 70bps per annum. Simple mathematics suggests that single digit portfolio returns will struggle to keep the industry value chain fed in the way that has enjoyed over past decades, with everyone forced to accept a reduced price. All this will occur at a time where the Regulator continues to consolidate the fragmented advice industry into more workable sizes, through increased reporting processes and responsibilities. Whilst there is no doubt that New Zealand is coming off a low base, there is a debate whether the enhanced regulatory framework will work in the geographically dispersed kiwi landscape, or whether the consumer will be any better off from the experience.

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Throughout this change, one thing that is certain is that the Accounting community, one of the groups spearheading the future of the financial advice industry, are already poised to receive payment for financial services rendered.

Early in the industry evolution there was a notable industry luminary who declared that platforms were an "opportunistic moment in time". In the 25 years that have passed since those infamous words, the platform industry has become an integral part of the value chain providing efficiencies for consumers, advisers and Managers alike. The same locomotives that powered many of these platforms in the early days remain in existence today, adding clumsy layers of expense for consumers in exchange for enhancing the operational gearing for the industry. The aggregation services provided by these platforms are now commodities, with price being the ultimate differentiator. As with all things technological, any migration from existing legacy platforms into new advancements won't occur until there is pressure from the consumer to change. This will likely be stimulated by greater transparency, reduced portfolio returns and the pursuit of an unbundled approach to wealth management. Imagine a time with greater flexibility and customisation of reporting of all assets – securitised or not – via a subscription technology solution. The move to little or no dealing costs will also allow for the customisation portfolio's (still managed by Asset Mangers). In this world, advisers will be provided with Administrative rights to assist with any ongoing guidance that they are commissioned to provide – much like the relationship Accountants have with Xero.

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There is no doubt that the biggest benefactors of the wealth management phenomena over the past 30 years have been the Managers of money. The operationally geared craft of managing money has enjoyed spectacular growth over this time, with an investment solution available for every possible event – and then some! And yet, many of these capabilities have struggled to deliver much more than index returns in recent times, delivering ammunition to the passive advocates. Many of these Managers have also exchanged the pursuit of out-performance for the gathering of assets as their boutiques have outgrown their original aspirations. In many cases, industry and investors alike have been attracted and retained by a good story told well as opposed to relying on a tested and repeatable investment process. During these agitations a higher-than-acceptable-proportion of money has continued to support poorly constructed businesses, that have hidden behind exceptional beta returns, whilst ensuring that their marketing pitch has deflected attention away from any difficult questions.

- Perversely the recent volatility of markets, which is commonplace in normal conditions, has started to highlight the underlying failings of many money Managers. Those groups who aggressively promoted their unique methods in managing money, are now defending their absence when the time counted. Whilst many will be working long hours to communicate patience, any prolonged downturn in markets or an inability for the Manager to enjoy a rebound will be reacted to swiftly through the departure of investors. The instinctive reaction from some Managers to increase exit constraints for their investors, will be met with revolt as investors and the industry become even more sceptical of volatility of return as a sensible measure of risk. We are facing a generation of investors who will be more risk averse as a result of their current investment experience and the more uncertain economic situation over coming years. Much of the money leaving growth-oriented investment options won't be coming back any time soon.

The losers in this turbulence will be those Managers offering a mediocre performance track record, have poor communication skills, and no longer have patient stakeholders to see them through the next few years. Don't be surprised to see at least one local money Manager close their doors in 2020 as the trend to larger funds with fewer small / mid-sized funds via mergers expected to accelerate. Consumers may ultimately have less investment choices but greater transparency on those choices. Many of these will be provided by large global Managers through the advancement and embracement of technology.

Upon reflecting on both the real and financial worlds, it appears that there will be more people seeking financial guidance from a diminishing universe of dispensers. Some advisers will blame the changing environment on their struggles, whilst others will avoid distractions and will never be busier. Technology will make the crunching of numbers, implementation and ongoing monitoring far simpler enabling advisers to focus on doing what they do best. Where the rules of engagement will change will be in how the consumer engages with the industry. Communication with clients is critical, particularly in terms of setting the appropriate expectations and ensuring they fully understand what they are buying rather than the industry's reliance on tables and warm fuzzy stories with little informative content.

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Volatility and lower portfolio returns will mean that fees will stick out, with consumers acutely interested in what they are getting in exchange. Preservation of capital will also bubble back to the top of the list, with consumers and industry having a renewed preference for easily explained and transparent investments. The departure of at least one local fund manager will no doubt recalibrate thinking around longer term vehicles such as KiwiSaver, aiding well establish money Managers to prosper in these uncertain times. If any of this sounds revolutionary, it shouldn't as its more of a reflection of getting back to the basics. In many ways, the virus has reminded us all that two plus two still equals four.

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