

Two Decisions

Protecting the value of advice

STANDUP ADVISOR

BY JOHN DE GOEY



So much of the “value proposition” of financial advice depends on perspective.

There’s a general consensus of what things cost (more or less), but there’s no real consensus on what things are worth.

In general, the two questions any investor needs to ask are:

1. Should I pay for active management or save money and use passive products and strategies?
2. Should I pay for financial advice or save money by doing this on my own?

Oscar Wilde is famous for having quipped that a cynic is a person who knows the price of everything and the value of nothing. Perhaps, all of us are cynics when it comes to personal finance.

Let’s start with what we can (mostly) agree on. Passive products cost about 50 basis points (bps). A basis point is 1/100 of 1%. Active products generally cost about 150 bps in a pure (unbundled) format. No advice ought to be free (although there are certain products that charge for embedded advice for do-it-yourself investors even though that advice is never sought nor received), while most people seem to agree that 100 bps is a reasonable level of compensation for qualified advice. We’re left with four combinations:

1. Passive without advice costs about 50 bps;
2. Passive with advice costs about 150 bps;
3. Active without advice (good luck in paying for only the active management part) costs about 150 bps; and
4. Active with advice costs about 250 bps

Now, let’s turn our attention to what investors might get in return. Specifically, “is it worth an extra 1% to employ actively managed products and strategies;” and “is it worth an extra 1% to get qualified advice?” Clearly, this is a circumstance where intelligent, fair-minded people may differ and where independent answers are required (i.e., the response to one question ought to have no bearing on the response to the other).

What does the research say? Well, taking an evidence-based

that the second option seems to make the most sense when looked at empirically.

What I find so intriguing is that, if one were to guess regarding the segmentation of the entire market today and divide it into the four options listed above, many people would come up with numbers like 8% for option 1; 1% for option 2; 16% for option 3; and 75% for option 4. As far as

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I know, no one has ever done this kind of segmentation, but I don’t think there’s any real doubt that the active management with advice option is by far the reigning champion of how Canadian consumers combine products with advice.

Most people would agree that advice generally really does add value. Unfortunately, many of those same advisors that add value for consumers often undermine their own good work by recommending products and strategies that actually subtract value. If anything, the evidence that active management subtracts value is even more definitive than the evidence that quali-

fied advice adds value. In spite of this, I’ve met dozens of advisors who purport to take a “research-based approach” to their practice while recommending actively managed products and strategies exclusively. Could someone who does this please explain the rationale? Is Wilde right? Is it just that most advisors don’t recognize that value is being eroded through active management? **AER**

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