WEEKLY REPORT JANUARY 2024

Private Asset Management Ltd

Brent Sheather is a Financial Advice Provider and a personal finance and investments writer.

QUANTIFYING THE LONG-TERM IMPACT OF ASSET MANAGEMENT FEES ON RETIREE INCOME AND INHERITANCES – Part 2

In the last story for 2023 we looked at a paper by James Mahaney entitled "Quantifying The Long Term Impact Of Assets Under Management Fees On Retiree Income And Inheritances". His analysis concluded that on average every 1% in annual fees results in a 15% reduction in income and a 23% reduction in the terminal sum i.e. what's left over for children/charities. This week we will consider the data we need to conduct a similar analysis for a typical balanced portfolio held by a retired client of a NZ financial planning firm. By using a range of estimated annual fees implicit in a typical "private wealth solution" we can ascertain their impact on income and terminal value.

Base case pre-fee performance is assumed to be equivalent to benchmark returns but we also model the impact of pre-fee performance at 1% pa below the benchmark. Research by Munnell et al of the Centre for Retirement Research at Boston College, "Investment returns: defined benefit vs. defined contribution plans" found that the rates of return over a long period for IRAs were less than half of those achieved by defined benefit plans. IRA's can be complicated from a tax perspective which often means they are managed by a financial advisor and because almost anything can go in an IRA i.e. individual stocks, bonds, managed funds, ETFs etc the potential for their performance to deviate from that of the market is substantial. Just recently, President Biden, at a function marking the introduction of a new DOL proposal requiring advisors to act as fiduciaries and mitigate conflicts of interest, warned financial advisors not to recommend high fee investment products that line their own pockets. In the DOL proposal, which focused on the roll-over of funds from 401Ks to IRAs, it estimated that conflicted advice costs retirement savers up to 1.2% annually. The switch from 401Ks to a IRAs, which seems to be pre-occupying both Mr Mahaney and President Biden, and the historic underperformance of IRAs is relevant to this discussion because it is similar to the switch from a Kiwisaver fund to a private wealth managed portfolio that retiring investors in NZ might consider. Hence the importance of modeling the impact of underperformance relative to the benchmark.

Fee structures in the private wealth space are particularly opaque – I see a few in the course of my work but to get a better picture I asked both MBIE and the FMA if they had any data that they could share. Both the FMA in NZ and the FCA in the UK are telling fund managers that they need to show that they are providing their clients with "value for money". Given that financial advisory charges are frequently much higher than fund management fees it's likely that this important cost structure will come under regulatory scrutiny before too long, overseas anyway. I also enquired as to whether the FMA thought the current disclosure regime was fit for purpose? In this regard many new clients who come to us with existing portfolios, some of whom employ professional trustees, have little idea of the total annual fees they are paying and, more importantly, no insight as to their long-term impact on the achievement of their investment objectives. Mr Mahaney quotes a 2021 paper by Muller and Turner, "Financial literacy, the high fee puzzle and knowledge about the importance of fees", also from the Journal of Retirement, which found "67% of surveyed participants underestimated or didn't know the importance of fees when investing". Ponzi schemes make the headlines but the biggest threats to most retail investors' investment objectives are high fees and underperformance resulting from conflicts of interest and investment strategies which don't meet the test of best practice.

In an email, the FMA said "The nature of the services provided by DIMS and Financial Advisers to their clients vary considerably across the industry (scope, comprehensiveness, complexity etc), as do the fee structures. This makes metrics like fees less useful for comparing between DIMS and Financial Advice Providers without also having detailed information on the nature of the services provided. Perhaps considering this, New Zealand law doesn't require DIMS or Financial Advisers to disclose their fees through the Disclose Register. This means that the FMA doesn't hold information on the average fees paid by private wealth clients to Financial Advisers. However, both DIMS and Financial Advisors are required to clearly disclose their fees (or estimated fees) to their clients so that their client can decide whether the particular service they'll receive is worth the cost." An MBIE spokesperson said: *"MBIE does not hold this data. We note that financial advisers are required to disclose fees to retail clients in a clear and concise manner, to help those clients make an informed decision about whether to seek advice from the particular adviser."* Well, that looks like financial planner fees are off the radar at the moment.

Despite the lack of input from the FMA and MBIE, let's have a go at estimating the total annual fees implicit in the standard "private wealth solution" typical of the offerings from a bank, financial advisor or stockbroker. Annual fees include those paid to the advisor to manage the portfolio, to fund managers, custodial and transaction costs. Estimates of these are detailed in the table adjacent. Note that some organisations bundle up their fee and custodial fees and don't disclose how they are split. Transaction costs include bid/offer spread and assumptions on levels of turnover. In order to keep fees down, make things look complex and allude to stock-picking skills many retail private banking groups tend to recommend individual stocks rather than funds and whilst this does reduce disclosed fees it also raises transaction costs and inevitably impacts performance. In the context of 6% from bonds and 8% from shares these fees look imposing. Indeed at the high end they are almost sufficient to appropriate the equity risk premium i.e. an all equity portfolio paying 3.5% pa in fees potentially delivers retail investors the risk of equities with the return of bonds. However let's take an optimistic view of fees, after all financial advisors are friends "who build lasting relationships and work with us to achieve our personal goals." The FMA tells us they are required to put our interests first so we will limit the analysis to total annual fees ranging between 1.0% and 2.5%.

Estimated Annual Fees For Private Wealth Clients	
Fees payable to financial advisors	1.0% - 1.5%
Fees payable to fund managers	0.5% - 1.0%
Custodial fees	0.1% - 0.25%
Transaction costs	0.3% - 0.8%
TOTAL	**1.9% - 3.5%**

Source: Private Asset Management

That's enough for this week and in two week's time we will analyze the output from the model.

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.