POWER FINANCIAL CORPORATION

HENRI-PAUL ROUSSEAU
VICE-CHAIRMAN

Is there any value in financial advice?

REMARKS TO THE
CANADIAN CLUB / CLUB CANADIEN
TORONTO, NOVEMBER 19, 2015

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HENRI-PAUL ROUSSEAU

Is there any value in financial advice?

REMARKS TO THE CANADIAN CLUB / CLUB CANADIEN, TORONTO, NOVEMBER 19, 2015

I feel honored to have been invited to address this distinguished audience here in Toronto at a joint event of the Canadian Club and of the Club Canadien.

I would like to begin by commending the Club Canadien de Toronto for its contribution to empowering the presence of French here in the Ontario capital. As its mission states, the Club Canadien is a forum providing Toronto francophones and francophiles with opportunities to meet and network, and engage in mutually rewarding discussion. In this way the Club acts as a catalyst in bringing together francophones from across the business, academic, cultural and government spheres. I applaud you for this work, which helps develop common understanding and strong relationships between our country's two great linguistic communities.

So, the question before us is a simple, yet quite polemical question: Is there any value in financial advice?

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Many of you will think that it is a rhetorical question, and I can't blame you for that.

Indeed, I hope to convey three critical messages to you in my remarks today:

1. The major source of the polemic around the value of financial advice lies in the confusion concerning what is the value of advice. If defined as the potential impact of financial advice on the creation of financial wealth over time, then as we will see, there is substantial value in financial advice.
2. Financial advice is in fact valuable enough that we should be concerned about wide access to it in our Canadian population. Tinkering with methods of compensation for financial advice in Canada, including embedded commissions in the case of mutual funds, may be detrimental to access to financial advice.
3. There is a need to improve the quality of financial advice in Canada and to achieve that objective, the industry should work with regulators.

So, to begin, let me note this fact: a vast majority of Canadians across all wealth bands rely on the guidance of a financial advisor for their investments.

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According to Investor Economics, 62% of the personal financial assets, which total about 3.6 trillion dollars as at the end of 2014, are held in accounts where a financial advisor is engaged. The remaining 38% of personal financial assets that are not held in an advice relationship are for the most part (that is two thirds) bank deposits and GICs, or assets held by financially-savvy, self-advised individuals.

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And contrary to the perception of many, financial advice is not only used by the rich. In fact, the proportion of households using financial advice is remarkably constant across income groups – it varies from 31 to 34%. This is much more than one would find in other countries such as the U.K., Ireland and Australia, where households use advice only at the level of 10%.

In addition, research has shown that in 40% of the cases where there is an advice relationship, that relationship was initiated with financial assets of not more than $10,000. That is very low. And in 70% of situations, investments were under $50,000 at the inception of the relationship.

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Now, it is fair to say that there is a wide variation in the breadth of advice: at one end of the continuum, no advice is provided; in the middle, transaction-oriented advisors provide a basic level of advice; and at the other end of the continuum, relationship-oriented advisors offer very sophisticated financial advice. Robo-advisors overlap the no advice/transaction-oriented advice range of the spectrum.

In this context, we applaud moves by the regulator to make account level rate of return and the cost of financial advice and product distribution more transparent, which will significantly improve the information investors have to evaluate the value of the advice they receive against the cost of that advice. We fully support CRM2 and I am pleased to share with you that Investors Group, which is part of the Power Financial Corporation group of companies, has been reporting account level rate of return compliant with CRM2 requirements for one, three, and five year periods to a vast majority of its customers for statement periods ending on June 30th, 2015. That is well ahead of schedule.

We support transparency and disclosure because we truly believe that there is value in the financial advice that we provide to our customers.

And here I come to my first critical message:

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Contrary to some widely-held views, we do not believe that the value of advice is mainly due to some superior way of picking assets – stock-picking, or mutual fund picking. Some studies seek to demonstrate that even in cases where an advisor generates some added value – some alpha compared with a market benchmark – that value is consumed by the cost of advice charged to the client. Even if that were true – and I think reality is more complex than these studies let you believe – that is beside the point.

Today, financial markets are much more complex than before, and the investor has many more choices: which investment strategies (active, passive or hybrid), which assets and risks (bonds, equities, absolute or relative return financial instruments, domestic or international risks, developed markets vs emerging markets exposures, real estate, hedge funds, alternative assets).

Financial advisors support their clients in what is a universe of complex financial products and strategies. The value they provide lies in helping clients: define their investment policy, construct their portfolios as well as rebalance them. That's what we call the advice on "beta." One must realize here that many beta recommendations may well be in conflict with the best "alpha" decisions. For example, rebalancing a portfolio after a major change in relative prices of assets may impose a decision to reduce the ownership of a great performing asset or great performing fund. Measuring the impact of advice at the alpha level will lead to a false conclusion.

But much more importantly, financial advisors encourage their clients to save in the first place, and help them stay the course in volatile times. That is the savings, investment and market discipline, supported by behavioral advice, that Morningstar has referred to as "gamma." This gamma component also includes credit and debt management advice, tax optimization as well as estate planning recommendations.

As Mr. Pierre Lortie has noted in a forthcoming paper, while individual financial literacy is laudable and valuable, for most individuals, and certainly in aggregate, it is not sufficient to compensate for individual behavioral weaknesses such as procrastination, inertia and loss aversion. That is precisely what financial advisors help to counterbalance.

In sum, it is not about "alpha," it is rather about "beta"; but actually, it is mainly about "gamma."

I would like to take this a bit further and show you that the value of financial advice is actually sizeable – in other words, it is worth seeking that "gamma".

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An econometric study by Professor Claude Montmarquette, of CIRANO, published in *Annals of Economics and Finance* shows that the presence of a financial advisor, when engaged for periods of four years or more, contributes positively and significantly to the level of assets when the impact of all other variables have been taken into account. For instance, after 15 or more years with a financial advisor, a household accumulates 2.73 times more assets than a non-advised household. That difference in outcomes is not explained by better returns, but is fully a result of improved savings discipline due to the advisor.

Moreover, you are certainly all aware of the debate on retirement readiness in Canada. It turns out that financial advice also has a positive contribution to the retirement readiness of Canadian households.

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A study by McKinsey and Company, published in February of this year, shows that households that do not have an employer pension plan, but are nevertheless on track to maintain their standard of living in retirement, are twice as likely to use financial advice as those households that are not on track.

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And finally, a study by the Conference Board of Canada, published in 2014, demonstrates that there are positive macroeconomic consequences to financial advice. The study shows that more financial advice, by leading to higher domestic savings, would create economic gains over the longer term, even if in the short term, real GDP growth would be somewhat lower.

As you can see, we are strongly convinced that there is value in advice, and, as a consequence, that it is well worth paying for this service.

So, how do Canadians pay for advice? In our market, broadly speaking, there exists two approaches to access and pay for financial advice. They largely depend on the size of the investment account.

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On the one hand, the fee-based advisor charges an asset-based fee directly to the investor; while on the other hand, the commission-based advisor is paid a trailing commission from the fund manufacturer. Regardless of the method of compensation, the services delivered and the costs are similar. As a result of CRM2, transparency and information provided to investors are essentially consistent between the two approaches.

For the investor, the main appeal of a fee-based approach is the ability to individually negotiate fees at higher account levels. This makes the model most suitable for the more affluent investor. For them, financial advice will typically represent a small fraction of their total investment portfolio. Most fee-based advisors typically require a minimum investment amount of over $100,000, and many require over $250,000 of assets prior to establishing an account.

These investment minimums make the fee-based advice model unsuitable to investors with more modest assets. That is why the vast majority of investors seek the more simple and accessible commission-based compensation model, where advisors will not typically require any investment minimum. Remember, nearly three quarters of the advice relationships began with financial assets of not more than $50,000.

In Canada, the commission-based compensation model makes it possible for entrepreneurial advisors to provide much-needed access to financial products and services to all households, regardless of income level, wealth levels, or geographic situation. These are households that higher-end fee-based advisors would consider unprofitable.

And at a time when large firms are reducing services, closing offices or moving their clients to on-line models, financial advisors can continue to grow their business by building long-term personal relationships with their clients, which is the best way to help individuals reach their financial goals at each stage of their lives.

By the way, we often hear in the Canadian financial media that mutual fund fees are substantially higher in Canada than in the U.S. This is incorrect. In fact, in Canada, fees for the financial advisor's services are usually embedded with the Management Expense Ratio, at no additional cost to the investors. In the United States, on the other hand, financial advice is charged separately. No surprise then that one gets the (erroneous) impression that U.S. Management Expense Ratios are lower than in Canada.

And now, here is my second critical message:

While some believe that the commission-based model commonly used by mutual funds to pay for an advisor results in an unmanageable conflict of interest, we take the view that it is an essential feature that makes financial advice accessible to middle-income and lower asset investors. Where there is an ongoing embedded compensation in the mutual fund, the advisor typically will incur a higher cost of providing advice than they initially receive from the manufacturer, but they do so in return for a reward over time through the trailing commissions, which will track the growth in assets for the investors. In such an instance, both parties' long-term financial interests are well aligned.

The access to advice is critical. Tinkering with the commission-based model might trigger an advice gap that could undermine the build-up of individual savings in Canada, retirement readiness of a large part of our population, and even long-term, economic development. Such an advice gap would be bound to also negatively impact the making of critical decisions by persons nearing retirement: on the timing of their retirement, on the optimal risk-return profile of their portfolios, and on the conversion of some of their savings into guaranteed income flows – at a time when more Canadians than ever are retiring.

In fact, that is precisely what we are seeing occur in the U.K. as a result of the Retail Distribution Review (RDR), in which payment of fees or commissions to distributors by manufacturers was prohibited. The resulting advice gap is very real and directly observable in a report done for the Financial Conduct Authority (FCA).

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The number of advisors has dropped by about a quarter since the announcement and implementation of RDR, and those who remain are being much more selective in which clients they retain, often choosing to focus on the up-scale affluent market for whom the fee-based model is well-suited.

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This has left many households with significantly reduced access to personal financial advice, which in turn has limited the savings discipline and positive investing behaviors that result from having a financial advisor. We then observe a sharp decline in the opening of investment accounts by less-affluent consumers.

This decline is of sufficient concern in the U.K. for Her Majesty's Treasury to have launched, in October 2015, a Financial Advice Market Review whose terms of reference specifically include "examin[ing] the advice gap for those people who want to work hard, do the right thing and get on in life but do not have significant wealth." The stated objective "is to produc[e] proposals ahead of Budget 2016."

I think that should be a warning sign for us all in our country.

Now, I still want to address the concerns that the very structure of the commission-based compensation model creates an irreparable conflict of interest between financial advisors and their clients.

In a recent CSA study, Professor Douglas Cumming of Toronto's Schulich School of Business reached two conclusions:

1. Fund performance attracts higher net sales of mutual funds, and
2. Net sales are more sensitive to fund performance under a fee-based model than under a commission-based model.

The study is interesting as it is based on a unique dataset that seeks to measure the relationship between compensation structures and flows of funds. This is quite novel and is to be welcomed in the current debate. I would note, however, that the methodology itself is quite complex and that the actual results are more nuanced than some of the early comments indicate.

More importantly, Professor Cumming's study must be included in the category of studies that intend to measure the impact of the value of advice on the "alpha," i.e. the impact of the compensation model on the probability of picking the best performing funds among all comparable funds of the same category, as measured by the net flow of sales, and not at the level of the impact on the client's overall wealth over time.

As I explained earlier, given the multi-faceted nature of the value of advice (alpha, beta, gamma), the impact of the value of advice must be measured at the net impact on the client's value of net wealth over time.

In sum, financial flows and financial performance are only one aspect of the ultimate goal of financial advice which is the build-up of financial wealth and security for clients.

To achieve that ultimate goal, the essential ingredient is the quality of financial advice. My third critical message to you is that there is room for improvement in that respect in Canada, and that the best way to do this is through cooperation between the financial industry and the regulators.

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We have a couple of good things already going for us in Canada.

1. Transparency and disclosure, under CRM2, will become standardized and make it possible for clients to compare the costs of different advisor relationships. For instance, reports on investment performance and on advisor compensation are being beefed up. It is to be expected that the industry, in Canada, will transform as this measure is being implemented. That will be interesting to watch.
2. In addition, the ethical standards set by IIROC and MFDA set a high bar for professional conduct.
3. Finally, current regulatory standards for advisors in Canada are comparable, and probably better, than standards in place in the United States, the U.K. and Australia – as confirmed by a legal review.

Still, there is room for improvement, as shown by the recent mystery shopping exercise for investment advice sponsored by the Ontario Securities Commission in collaboration with IIROC and MFDA.

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I would submit to you that the following three measures would help to permanently lift the quality of financial advice in Canada, mitigate further potential conflicts of interest and ensure trust between clients and financial advisors, which is at the root of a successful client-advisor relationship:

1. Define and enforce professional qualification standards as embodied in professional designations, such as Certified Financial Planner. That supposes a common formal training with an agreed curriculum.
2. This could be supplemented, as in other professional sectors, by some form of permanent training/education.
3. Upholding these standards and ensuring that they are continually met is also of the utmost importance. For that purpose, it is essential that the regulatory authorities and the financial industry cooperate to develop appropriate tests of the value created in a long-term client-advisor relationship – not only, to be clear, in a first meeting between a potential client and an advisor.

Let me now conclude.

My three critical messages to you are:

1. The value of financial advice resides not in “alpha,” it is rather in “beta”; but actually, it is mainly in “gamma”;
2. Mind the advice gap, and to this end, be careful with compensation models, in particular embedded commissions;
3. Let us have industry and regulators work together to improve the quality of financial advice for Canadians.

With that, I thank you for your kind attention today.

Is there any value in financial advice ?

1. Value of financial advice
   Criterion: impact on creation of financial wealth over time
2. We should be concerned about Canadians' access to financial advice
3. Quality of financial advice is key

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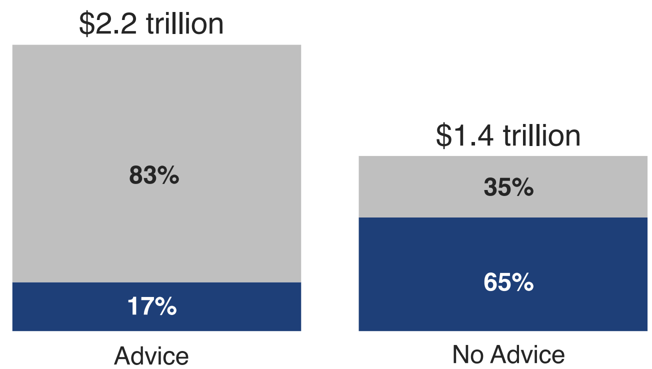
End-2014, most personal financial wealth in Canada is invested with advice



Total: $3.6 trillion

SOURCE: Investor Economics, 2015 Household Balance Sheet Report

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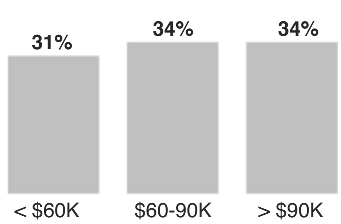
Contrary to perception, advice is not only used by the rich

Use of financial advice

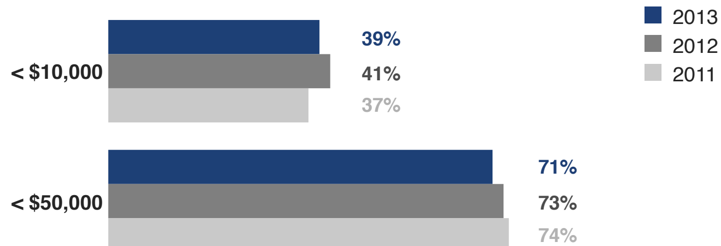
Percent within income group



Annual household income

Value of Savings/Investment when first started using an advisor

Percent of total respondents



Pollara Research (2013). Respondents were asked "When you first started using a financial advisor, which of the following categories best represents the total value of your household's savings and investments at that time, excluding your primary residence?"

SOURCE: Ipsos-Reid Survey, 2014
IFIC, Paying for Advice: Why Options are Important, August 2014

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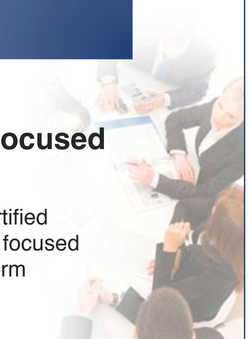
From no advice to high-touch intermediated advice, a continuum



No individual advice

> DIY investor buying directly

Low-touch, transaction-focused advisors

> Point-in-time advice focused on basic planning and product recommendations

High-touch relationship-focused advisors

> Advisor (often certified financial planner) focused on holistic long-term financial planning

← Robo-advisor →

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What advice really is

Investment management
α Alpha

- "Stock picking" or "Mutual fund picking", e.g.
  - Which stocks?
  - Which funds?
- Market timing

Investment policy
β Beta

- Asset allocation, e.g.
  - How much exposure to markets?
  - How much local vs. international assets?
- Investment style, e.g.
  - Amount of active performance seeking?
  - Suitability of investments to risk profile

Behavioral
γ Gamma

- Engagement to save
  - Start saving
  - How much to save
  - Staying the course
- How best to save
  - How to take advantage of fiscal incentives
  - Best product structures

SOURCE: Morningstar, Alpha, Beta, and Now… Gamma, 2012

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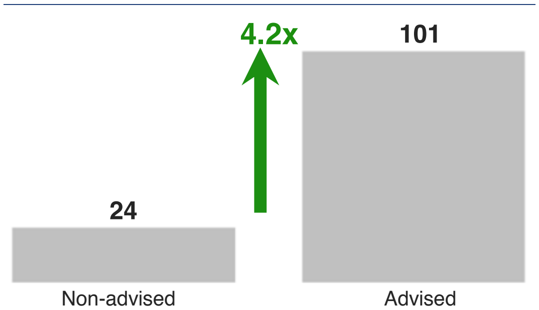
Advice has sizeable value

1 > Impact on savings and wealth

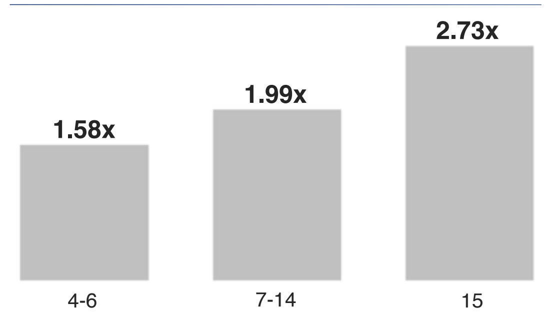
SOURCE: CIRANO, Econometric Models on the Value of Advice of a Financial Advisor, 2012
Also published in: ANNALS OF ECONOMICS AND FINANCE 16-1, 69-94 (2015)

Median current financial assets

$ thousands



Ratio of advised vs. non-advised current financial assets



Years of financial advice

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Advice has sizeable value

2 > Impact on retirement readiness

SOURCE: McKinsey & Company – Building on Canada's Strong Retirement Readiness, 2015

Profile of mid- to high-income households with no employer plan

	Low savers 46% ready for retirement	**Healthy savers** 95% ready for retirement
Financial advice usage:	**27%**	**49%**

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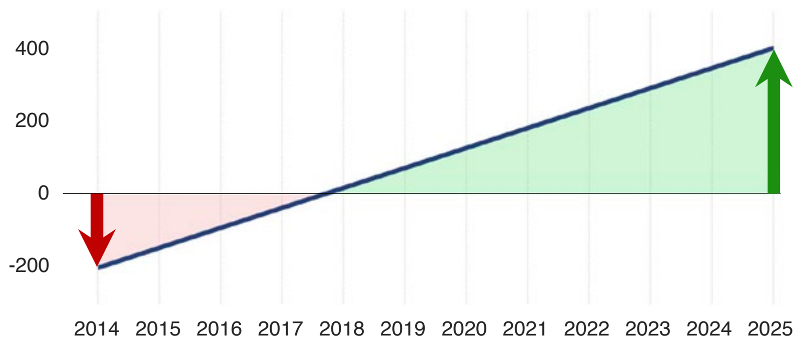
Advice has sizeable value

3 > Impact on the economy

The Conference Board of Canada

Projected impact of a voluntary increase in household savings

Difference from base-case scenario, 2007
$ millions



Negative short-term economic impact of savings largely offset by positive long-term effect on economic growth

SOURCE: The Conference Board of Canada, Boosting Retirement Readiness and the Economy Through Financial Advice, 2014

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Paying for advice: two broad approaches

Fee based

> Ability to individually negotiate fees at higher account levels

> High minimum investment amounts (> $100,000)

Typically high net worth/affluent

Commission based

> Typically no investment minimum required

> Trailer commission = alignment of interests between investor and advisor

Typically middle-income

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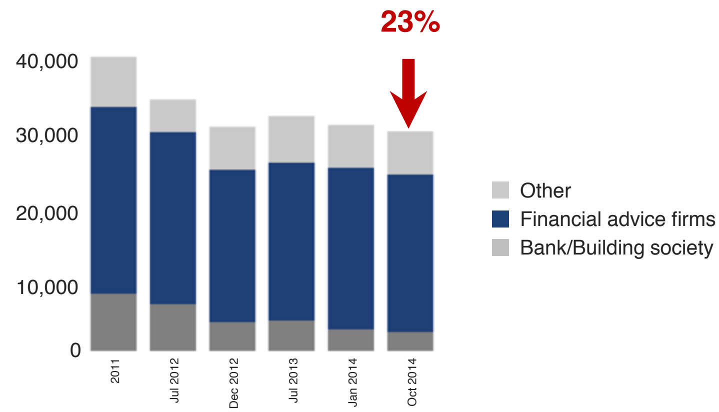
The risks of an Advice Gap: Post Retail Distribution Review, there are a quarter fewer financial advisors in the U.K.

SOURCE: Europe Economics, Retail Distribution Review – Post Implementation Review December 2014, for the FCA's post-implementation review

Change in the number of advisers between 2011 and 2014 by type of advisory firm



SOURCES: RS Consulting (2011) and FCA (2012 onwards).

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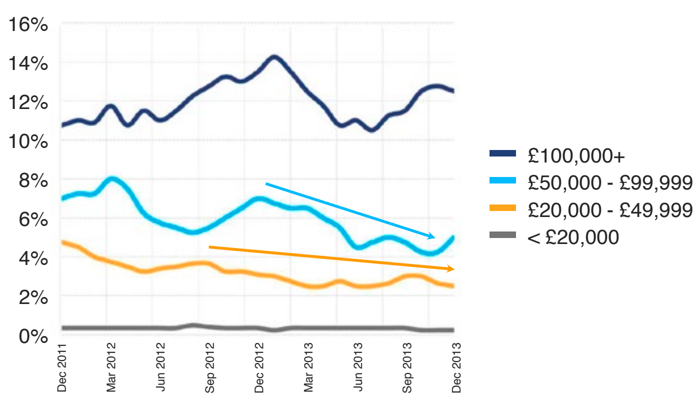
Advice Gap: Post Retail Distribution Review, the opening of lower asset investment accounts has dropped by half in the U.K.

SOURCE: Europe Economics, Retail Distribution Review – Post Implementation Review December 2014, for the FCA's post-implementation review

Proportion opening investments in the last year, by value in savings & investments segments



NOTE: Base for the figures is consumers (18+) opening an investment (this is not defined but would include retail investments).

SOURCE: © GfK NOP Ltd, Financial Research Survey (FRS), 6 months rolling data

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A strong basis in Canada for quality financial advice

SOURCE: Laura Paglia, Torys, 2013

Transparency/disclosure

> **CRM2**
> - > Investment performance report with dollar weighted rate of return
> - > Report on charges and other compensation

Ethical standards

> **IIROC**
> - > High standards of ethics and conduct
> - > Suitability

> **MFDA**
> - > Deal with clients fairly, honestly and in good faith and observe high standards of ethics and conduct
> - > Suitability

A legal review commissioned by IFIC has found that the Canadian regulatory system in this respect is as strong, if not more, than regulatory systems in the U.S., the U.K. and Australia

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Trois mesures pour améliorer la qualité du conseil financier au Canada

1. Standards uniformes de qualification professionnelle (exemple: Planificateur Financier, Pl. Fin.)
2. Formation continue
3. Tests de la valeur créée dans une relation de long-terme conseiller-client (à développer par l'industrie financière et les autorités réglementaires, en collaboration)

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Conclusion – trois messages essentiels

1. Valeur du conseil financier:
   (Alpha) ➡ Beta + **<u>Gamma</u>**
2. Accès au conseil financier
3. Qualité du conseil financier

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