Advisor Tipping Point:

Waiting for The Substitution Effect

John J. De Goey

According to Investopedia, the "substitution effect" is: the component of a change in demand for a good as a result of a price change that can be attributed to substitution between different goods. As prices rise, consumers will replace more expensive items with less costly alternatives. Conversely, as the relative price of a good falls, consumers will purchase more of it relative to substitute goods. It should be obvious that the substitution effect can have a powerful impact on consumer decision-making if it is understood and acted upon. Having most of our clothing manufactured in China has allowed consumers to get more and sometimes better clothing for a notably lower price than a decade ago.

Here's another example offered by Investopedia: when the price of pork increases compared to the price of chicken, consumers are more likely to substitute pork consumption with chicken consumption. The quantity of pork demanded declines and the demand for chicken increases. In this case, the chicken is a substitute good. In brief, consumers are presumed to have the tendency to replace or substitute normal economic goods with cheaper alternatives when prices change or when new, cheaper, products are introduced.

Unfortunately, that's not what happened in Canada when Vanguard introduced a number of low-cost, actively-managed mutual funds a year ago. The base Management Expense Ratio (MER) for these products is set at a reasonable 0.5%. Despite what should be a game-changing lower cost, it seems many advisors are treating these new funds much the same way they treat Exchange Traded Funds (ETFs), and for essentially the same reasons. The reasons given by most Mutual Fund Dealers Association (MFDA) registrants is that they do not recommend ETFs because they are "too new" (they have been around for over 20 years!) or that they believe in active management (Canada is a world leader in active ETFs) or that their firm is still not set up operationally to accommodate ETF purchases (how long does it take, really?)

The fact is the new Vanguard mutual funds are both cheap and actively-managed, yet are being largely ignored by Canada's mutual fund registrants. Why? The answer is obvious to anyone who knows the industry. Generally speaking, our MFDA registrants don't look for the best funds, they look for good funds that pay an embedded compensation. As with ETFs, no matter how good the fund is, many MFDA registrants won't even consider recommending it because the dirty little secret is that their business model (getting paid by trailing commissions) drives their product recommendations. Henry Ford is quoted as saying: "you can have any colour car, as long as it is black." Our MFDA registrants seem to be saying, "you can have any mutual fund you want, as long as it pays me a trailing commission."

To me, this serves as yet another example of why traditional neo-classical economics is presumptively reasonable and correct in theory, yet demonstrably inaccurate in practice. Traditional economics presumes that rational individuals are utility-optimizers who are constantly on the lookout for the best deal when making financial decisions for themselves. By extension, people who are working for valued clients should also be looking out for what is best for them, too. There's a clear opportunity to substitute high cost products out and replace them with better, lower cost products while keeping the advisor's compensation unchanged, but many advisors refuse to do so. It seems the reasons are varied:

- Some believe their role is to pick out-performing products (which explains why index-tracking products are not recommended).

- Some believe cost is of little or no consequence (voluminous research shows that it is).
- Some are simply mortified to have a frank discussion about the cost of advice (even though Client Relationship Model, version 2 (CRM II) has mandated that this be disclosed annually for a few years now).

Inelasticity

This brings us to the related concept of elasticity. Our friends at Wikipedia have this to say:

In economics, elasticity is the measurement of the proportional change of an economic variable in response to a change in another. It shows how easy it is for the supplier and consumer to change their behaviour and substitute another good, the strength of an incentive over choices per the relative opportunity cost.

It gives answers to questions such as:

"If I lower the price of a product, how much more will I sell?"

"If I raise the price of one good, how will that affect the sales of this other good?"

"If the market price of a product goes down, how much will that affect the amount that firms will be willing to supply to the market?"

For all the talk in the media for nearly a generation about the need to lower overall costs, I remain amazed at the indifference to product cost shown by many advisors. Their inelastic (read: largely unresponsive) reaction to the opportunity to implement significant price reductions for their clients is astonishing. As the saying goes, people respond to incentives. Trailing commissions are salient determinants of what advisors recommend to their clients. My reading of the situation is that advisors are quite happy to recommend inferior products if they are only held to a general suitability standard. Basically, as long as a product is not brazenly unsuitable, it is suitable enough.

There was considerable anecdotal evidence prior to 2015 that trailers caused advisor bias and there were two ground-breaking reports released that year that proved as much beyond any reasonable doubt. In 2018, when regulators had a chance to protect consumers by banning embedded compensation, they caved to industry interests and allowed the pro-embedded compensation bias to persist.

Fiduciary Standard

The only people that I see who are at least trying to manage costs on behalf of their clients are fee-based advisors. An advisor who charges an asset-based fee is free to make product recommendations based on product merit alone. Among fee-based advisors, the subset that seems most likely to consider product cost are the Portfolio Managers. There are only a few thousand Portfolio Managers (PMs) in Canada (likely less than 4% of the total advisor population), but those are the people who are held to a higher standard. Simply put, unlike other advisors, PMs are fiduciaries and are therefore required by law to put client interests first. Stated somewhat differently, PMs aren't allowed to weasel their way out of making recommendations that are less than best for their clients.

There can be little doubt that there are still some fundamental disagreements between PMs about market efficiency and the overall utility of trading individual securities to attempt to add value for their clients. While my position on market efficiency has been well documented, I at least respect those people who go about their business by building diversified, balanced portfolios using individual securities as portfolio building blocks when part of their rationale is saving on costs.

Presumptive Logic

You know what really bugs me? Those ads you often see that show an actively-managed mutual fund's stellar past performance. What the heck are those ads supposed to prove? They're not as ubiquitous as they used to be, but they're just as presumptive and nonsensical as ever.

Here's the thing: about 50 (!) years ago, Michael Jensen published a paper showing that past performance is doubtful as a predictor of the future. Then, about 20 (!) years ago, Mark Carhart published what has become the industry standard on the subject and his paper showed the exact same thing. At least six or seven other major studies have been published over the past generation and they all say the same thing, too. The basic finding is as follows… tell me if you've come across a statement like this before: "Past performance may not persist and should not be relied upon". Have you ever seen anything like that statement? I'm guessing the answer is "yes", since it has appeared on pretty much every prospectus, fund facts and advertisement ever released for over a quarter century.

This is sort of like the "if a tree falls in the forest" question. Trees that fall where no one hears them are

sometimes deemed to have not made a sound. What about past performance being indicative of anything meaningful or repeatable? Past performance for mutual funds is every bit as reliable as reading chicken entrails, sun spots and / or tea leaves in predicting future performance. When I say, "every bit as reliable", I mean "equally and utterly useless".

I use the word "useless" deliberately and advisedly. Even the people at Morningstar have admitted that choosing funds based on lower MERs is a more reliable predictor of future performance than the star ratings (which are based on past performance) they produce. So, if the information is useless, why are there all these ads running that tell us about past performance? I'm guessing it's because people have the misguided belief that it's useful. Now, is it advisors, their clients or both who believe this?

Why not test to find out? If you come across an advisor who professes to believe in "investor literacy", ask that advisor what he or she is doing to disabuse investors of past performance meaning anything useful at all. My sense is that the ads run because they are persuasive. In other words, there are people out there who believe that this utterly useless info has some actual utility. More to the point, I believe the ads run because advisors persist in implying that past performance is a reliable predictor of the future when it is not. Accordingly, clients believe it because their advisors believe it.

Dalbar QAIB

To make matters worse still, the people at Dalbar publish an annual report called the *Qualitative Analysis of Investor Behaviour (QAIB)* for the average investor. They show there is clear evidence of performance chasing (i.e., investors buy high based on recent strong performance and sell low based on recent underperformance) where investors are far worse off because of the activity.

I asked Cory Clark of Dalbar if the company has done any work to break down the behavioural quirks of those people working with advisors and those working as Do-it-Yourself (DIY) investors. After all, if most people in the study are working with an advisor whose advice is being followed, it might be more appropriate to call the study QAAB – the Qualitative Analysis of ADVSOR Behaviour. He says the work has not been executed to that degree of granularity. Here's his verbatim response:

"You make an excellent point. QAIB's "Average Investor" is advisor-directed and self-directed investors. The challenge with such a study that divides the self-directed from the advisor-directed is getting the data. We've been able to do similar analysis on a private level but never able to get aggregate results that we could report on in an industry report. To get a statistically significant sample, we would need buy-in from a large broker/dealer or custodian that has the data. So far, we have not been able to do so but are always trying to crack that code, so to speak."

It seems that past performance data is almost certainly WORSE than useless. If it was simply useless, people would be neither better off nor worse off and they would pay no attention to it. Instead, it seems people make investment decisions based on what should be considered useless information as if the information was useful and, as a result, are decidedly worse off than they would be if they simply ignored it in the first place! It's like using a map of Ottawa to find your way around Toronto. If you simply threw away the map and tried to navigate the city, you'd be more likely to reach your destination.

Some Advisors (Finally) Get It; Many (Still) Don't

What we're left with is a perverse situation where some advisors act as though past performance is important, even though it isn't… while simultaneously acting as though product cost isn't important, even though it is. These well-intended, but misplaced priorities are what some people have referred to as "misguided beliefs". The problem is likely even worse than it seems, because some advisors overwhelmingly don't see this is a problem. They think they're doing everything right. No one ever worked on solving a problem that didn't exist. Perhaps the reason we have seen so little progress to date is that the industry cannot see the forest from the trees. Some advisors are biased in favour of expensive, actively-managed, embedded compensation investment products—primarily because they honestly believe those products are what's best for their clients.

In 2018, ETFs outsold mutual funds in Canada for the first time in a decade. At the midway point of 2019, that trend has continued. Belatedly, it seems there are finally more than just a few advisors who are waking up to evidence and genuinely doing right by their clients. I believe we are at a tipping point. It appears we've finally reached the point where most advisors are prepared to engage in the substitution effect as a legitimate, tangible value-add for their clients.

If you are working with an advisor who still recommends

expensive products without offering cheaper options, you need to confront your advisor to demand answers. The evidence you'll need in your confrontation can be found at: www.standup.today. How long we must wait for laggard advisors to give up their addiction to expensive, embedded compensation funds? As with people who held on too long to their buggy whips and eight-track players, history will not be kind to those who resisted change with the facile attitude that it will go away if ignored. The dismissal of evidence is about to get its comeuppance.

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He talks about *MoneyGaps*, a platform that helps advisors provide financial planning advice and quantify it for their clients.

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