PORTFOLIO STRATEGY

Why hiring an adviser who's offering low fees could be a terrible move for your finances

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The problem with seeking the lowest-cost investment advice is that you may end up with the lowest-quality advice as well.

Savvy investors generally work on the principle that paying less is unquestionably a good thing. Fees eat into investment returns, so there's some logic to this. But advice may be an area where pursuing the cheapest possible fee produces a worse outcome for your finances.

A study by the PriceMetrix unit of consulting giant McKinsey & Co. has found that the cost of having a fee-based account with an adviser fell modestly last year for accounts of all sizes. Example: The fee for accounts of $1-million to $1.5-million fell to 1.08 per cent from 1.13 per cent in 2016 in the North American market.

Cheering fee reductions seems the right thing to do, even if they are modest. But the PriceMetrix analysis makes you wonder.

It turns out the declines in overall fees were driven by a minority of advisers who lagged the majority in two key investment industry measures of success. They attracted less new business and generated less overall growth in the revenue they made for themselves and their firms. Some are losing clients, rather than building their businesses.

The implication here is that cutting fees is a defensive move by advisers who are having trouble competing on overall service. "The adviser who is chopping prices may not be the best deal for you," said Patrick Kennedy, a co-author of the study.

There's a segment of investors, some of them do-it-yourselfers and some of them advised, who are religious about low fees and determined to drive them as low as possible. The PriceMetrix study suggests another path for investors with advisers – demand greater value as much as or more than lower fees.

In a fee-based account, you pay your advisory firm a percentage of the value of your account. On an annual basis, these fees would range from roughly 1 per cent for large accounts approaching seven figures to between 1.5 per cent and 2 per cent for smaller accounts.

You can also pay an adviser through commissions buried in the cost of owning mutual funds (called trailing commissions) or on a per-trade basis. But fee-based accounts dominate in the advice business. PriceMetrix says 46 per cent of assets and 63 per cent of revenues at North American financial advisory firms were fee-based in 2017.

The overall level of fee cutting in 2017 looks more substantial when you focus just on the 30 per cent of advisers who cut fees. The average fee decline in that group was 0.23 of a percentage point, which is a lot. The other 70 per cent of advisers averaged a fee increase of 0.04 of a point.

Let’s not be naive about fee cuts – they matter for sure because they help returns. The investment industry would love for us investors to go back to the old days of being oblivious about fees because that would mean more revenue and profits. But there’s a difference between seeking the lowest possible cost in a basic investing product such as an exchange-traded fund and the fee paid to the person whom you’ve chosen to guide you to financial success.

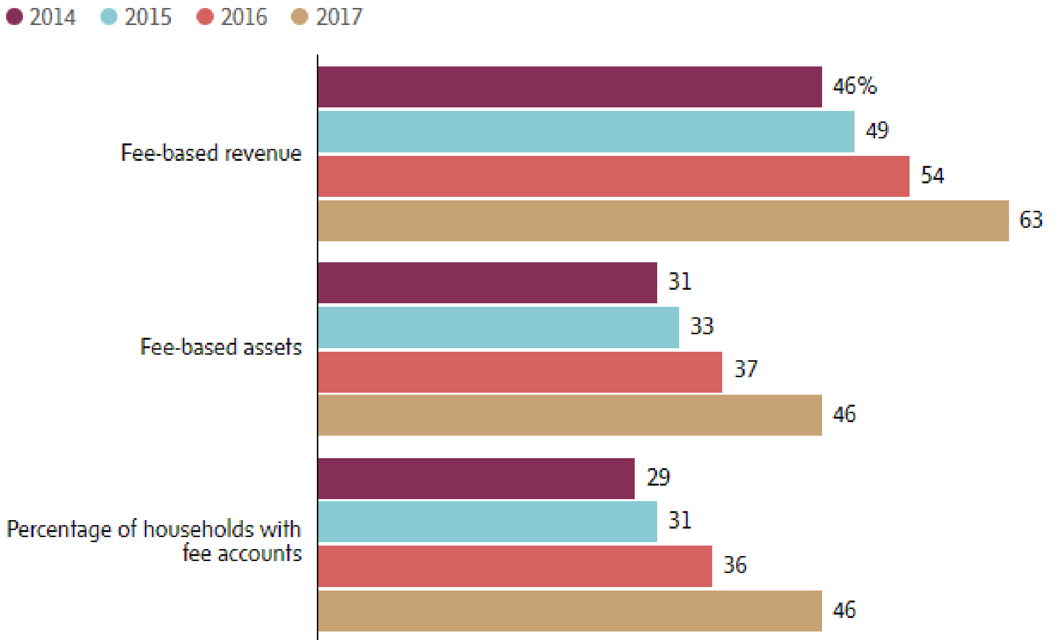
According to Mr. Kennedy, the investment-advice industry is evolving in a way where low fees suggest a lesser level of service. This is by no means a bad thing in some cases. Robo-advisers provide a hugely important service by offering low-cost portfolio management to investors who don’t want to manage their own money and who lack the bucks to attract the attention of a full-service adviser.

But robo-advisers are for the most part an econo-model of investing – portfolio management, with little or no personalized, hands-on financial planning. When you have a full-service adviser, you expect more than that.

The PriceMetrix study suggests the advisers holding the line on fees are the ones providing that higher level of service. They generated about 13 per cent more in new assets last year on a per-adviser basis, which means they’re more effective at attracting new clients. Hold-the-line advisers also produced revenue growth of 12 per cent in 2017, compared with 9.4 per cent for the advisers who cut fees. Revenue growth can come from adding new clients and increasing the value of current accounts.

Rise of the fee-based account

There are a few different ways to pay an investment adviser, but the fastest-growing is the fee-based model. Clients pay a percentage of their assets to their advisory firm that typically works out to between 1 and 2 per cent, depending on account size and services provided. This chart shows how assets in fee-based accounts have grown in accounts held at investment advice firms in Canada and the United States.



THE GLOBE AND MAIL, SOURCE: PRICEMETRIX, A UNIT OF MCKINSEY & CO.

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Household assets managed

Here are year-over-year pricing changes (shown in basis points) for fee-based accounts based on household assets (shown in $millions) held by clients. A basis point is a hundredth of a percentage point.

THE GLOBE AND MAIL, SOURCE: PRICEMETRIX, A UNIT OF MCKINSEY & CO.

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Mr. Kennedy sees these differing results as being a reflection of a realignment in the advice business in recent years. A decade or more ago, advisers were mainly focused on building and maintaining an investment portfolio for clients. Since then, many advisers have added services such as financial, estate and tax planning.

The result has been to lessen the value of advice that just covers portfolio-building to an extent where advisers who do business this way are struggling. That’s where fee cuts come into play. “If the value proposition isn’t there and you’re already losing clients, lowering prices seems like the natural thing to do,” Mr. Kennedy said.

So how do you tell whether you’re getting value for the fee you pay your adviser. Here are some thoughts:

- People over investments: Your adviser focuses more on you and your situation than on the investments you’ll buy.
- Communication: You have annual meetings face-to-face and more frequent communication by e-mail or phone.
- Transparency: Fees and commissions are out in the open.
- Financial planning: Comprehensive fact-finding by your adviser about your current financial situation and goals is turned into a guide on how to get where you want to go.
- Retirement: You know how much you need to save and are confident your current investment plan will get you there.
- Taxes and estate planning: Wills and powers of attorney are looked after, and opportunities to minimize tax have been explored.
- Questions are welcome: Your adviser is happy to answer specific questions such as whether you can draw some of your retirement savings to help your kids buy a house.

Mr. Kennedy sees communication as being essential to the value he gets from his own adviser. “The No. 1 value that I get from my adviser is that they can talk to me about investments and they can talk to my wife about investments. I can’t talk to my wife about investments. It’s almost a marriage counsellor kind of thing and I’m willing to pay for that.”