For Advisor Use Only:

Clients Need To Know What Their Advisors Do

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I get a lot of marketing material from other investment firms through email blasts, direct mail and industry publications. It keeps me up-to-date on the latest products, new features and limited time offers. At times, I can barely contain my excitement.

I always look forward to receiving material marked 'For Advisor Use Only'. These documents are labeled as such for an obvious reason – the issuing institutions don't want clients to get a hold of them. But what should an advisor be privy to that a client shouldn't? One word, commissions.

First, a little background. Transparency around commissions and advisor compensation is poor. Few investors know the full cost of the products they invest in and how their advisor is compensated. It is common practice in Canada for advisors to receive a "trailer fee", which is an ongoing service commission for keeping clients invested in a product. For funds that are sold without an up-front commission, the trailer fee is usually 1% per annum for equity funds and 0.5% for bond funds. This fee is paid by the investment firm (to the advisor) and is included in the management expense ratio (MER) of a fund.

This structure is known as embedded compensation. In other words, the fee paid to the advisor is embedded in the total fee of the product and is not easily visible to the client. It can be found in the depths of a fund's prospectus, but few investors scour these voluminous documents for such details. The practice of embedding commission in a financial product is banned or in the process of being phased out in Australia, the U.K. and the U.S., with conflict of interest cited as a key reason. The practice, however, is still prevalent in Canada.

Advisors need and deserve to get paid, but the commission they receive should be clearly visible to investors as a fee separate from the MER. The fees you pay your accountant or lawyer are clearly laid out, as should be the fees you pay your investment advisor (Note: Not all advisors sell commission-embedded products. There is a small, but growing community of 'fee-for-service' advisors who sell funds with no trailer fees attached. These advisors charge a clearly disclosed fee for their services). Many advisors work hard for their clients and deserve the compensation they receive, but others would prefer that you didn't know how much you're paying them.

What makes restricted marketing materials juicy is that they often provide details on the trailer fee paid to advisors to sell the product. Some firms up the ante on certain products from 1% to 1.15% or even 1.25% to entice an advisor to sell the product not based on its merit, but because of its higher commission. And the client is kept in the dark because the information was not meant for their eyes. The potential for a conflict of interest between the advisor and client is evident. I recently received a marketing document that highlighted a "Premium Trailer" of 1.15%. I wonder how many advisors who sold the fund disclosed this to their clients?

The mutual fund business is heavily regulated, yet is under increasing criticism for poor transparency on issues such as fees and performance. Fortunately, efforts are underway to improve this. The Canadian Securities Administrators (CSA), which is a voluntary umbrella organization of Canada's provincial securities regulators, recently published a set of proposals that would increase the disclosure required by dealers and advisors to clients about the costs and performance of their investments.

The proposals include requirements (by dealers and advisors) to provide annual reports that show: (1) in dollar terms, what the dealer/advisor was paid for the products and services it provided, and (2) in dollars and percentages, how the client's investments performed during that year and over longer periods. Regulators hope to finalize the proposals next year and have them implemented within a three year period.

Canada doesn't appear to be following the path of other countries in banning commissions tied to financial products (for the time being). Enhanced disclosure and reporting, however, would go a long way in better serving investors by providing them with the information they need to properly assess the value of advice they're receiving, let alone the performance of their portfolios.

If the industry wants to improve its reputation, For Advisor Use Only materials and premium trailers need to go. When it comes to fees and performance, clients should know what their advisors know.

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