THE INVESTMENT FUNDS INSTITUTE OF CANADA | L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA

The Value of Advice Report 2012

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Introduction

The durable value of advice is being confirmed in more and more research studies here in Canada and internationally. This report, *The Value of Advice Report 2012*, highlights a number of these studies.

For example, the report summarizes a groundbreaking Canadian study from the Centre for Interuniversity Research and Analysis on Organizations (CIRANO) in Montreal, which shows that advice positively and significantly affects the level of savings of individuals after correcting for a host of socio-economic variables that also affect wealth.

Evidence examined from the United States shows that advised investors have a greater likelihood of adopting a long-term investment strategy than non-advised investors. In addition, research from Australia shows that financial advice provides significant macroeconomic benefits through the gains it promotes in individual and national savings.

> Corroborating evidence from these diverse sources continues to confirm the role of financial advice in helping individuals reach their long-term financial goals

The *2012 Value of Advice Report* demonstrates that there is a mounting body of evidence in Canada and elsewhere of the value of financial advice. Corroborating evidence from these diverse sources continues to confirm the role of financial advice in helping individuals reach their long-term financial goals and underscores the importance of promoting a viable advice sector as a public policy objective.

An Overview THE DEMAND FOR ADVICE AND THE BENEFITS OF ADVICE

Financial advice provides a wide array of value-added benefits for which there is strong investor demand.

This is a global phenomenon: according to a 2011 Investor Education Fund report, five out of six Canadian investors are clients of financial advisors[1]; in the United States, the Investment Company Institute (2010) reports that 81% of U.S. households owning mutual funds have a financial advisor; in Germany, roughly 80% of individual investors rely on financial advice for investment decisions (Bluethgen et al., 2008); and in the Netherlands, approximately 51% of households with an investment portfolio use financial advice (Kramer and Lensink, 2012).

Such high demand is a direct result of the fact that advice allows investors a better chance of:

- Accumulating greater wealth through better savings behaviour;
- Building towards a more comfortable retirement;
- Selecting tax-efficient investment vehicles;
- Maintaining a long-term investment strategy;
- Protecting against poor financial decisions; and
- Avoiding emotional investing habits.

These benefits show themselves in a number of ways, including having a greater sense of control of one's finances, and the peace of mind that comes from greater confidence in the future.

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Canadian investors are clients of financial advisors

[1] Investor Education Fund, *Investor behavior and beliefs: Advisor relationships and investor decision-making study.* Written by The Brondesbury Group, 2012.

Recent Canadian Research

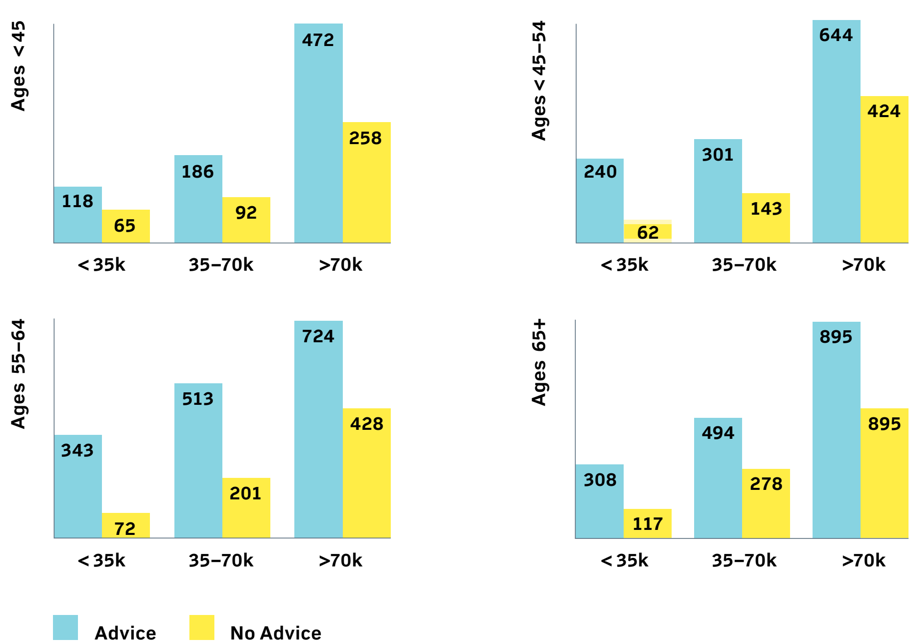
A Review of Research Findings from 2010 and 2011:

IFIC initiated its study of the value of advice with the release of Value of Advice Reports in 2010 and 2011.[2] Both reports examine the portfolio characteristics of advised and non-advised investors based on data from Ipsos Reid[3]. The reports provide strong evidence of an empirical linkage between having advice and successfully accumulating financial assets.

In particular, the 2010 report demonstrates that:

- Advised households have **substantially higher investible assets** than non-advised households, regardless of household income level;[4]
- Advisors help individuals **choose the right vehicles and plans** to optimize outcomes for their own unique circumstances; and
- Advisors help investors **choose the right asset mix** for their specific circumstances, objectives, and risk tolerance.

Household Average Net Worth by Age Group and Income Group



Source: Ipsos Reid Canadian Financial Monitor

IFIC's Value of Advice: Report 2011 provides confirming evidence that, when controlling for both age and income, the net worth of advised individuals is significantly greater than that of non-advised individuals (as shown in the figure to the left).

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[2] Investment Funds Institute of Canada, "Value of Advice: Report 2010" and "Value of Advice: Report 2011".
[3] Additional support is provided from research by Pollara Research in 2011.
[4] This result is part of the Ipsos Reid *Canadian Financial Monitor* study, which is based on a longitudinal database about Canadian households' financial behaviours and attitudes. This ongoing market research survey has been run continuously since 1999 and is widely used by government agencies and financial institutions to monitor trends in Canadian consumers' financial services behaviour.

Moreover, research from Pollara showed that **most investors first begin to work with an advisor when they have only modest amounts of savings.** The *2011 Pollara Investors Survey* reports that 37% of mutual fund investors had less than $10,000 in total household savings and investments, excluding their primary residence, when they first started using a financial advisor, and 57% had less than $25,000 when they started using an advisor, corroborating earlier evidence from Ipsos Reid.[5]

The Value of Advice: Report 2011 also confirms findings that advised households are more likely to use tax-efficient savings vehicles than investors without advice. Finance Canada estimates an after-tax yield improvement of registered plans at approximately 1.5%. In other words, assets held in registered form earn 1.5% more after tax than the same assets in non-registered form.[6]

The results are very indicative of a positive contribution from advice on the accumulation of wealth.

More definitive results are now available with the release of the 2012 study "Econometric Models on the Value of Advice of a Financial Advisor" by Claude Montmarquette and Nathalie Viennot-Briot of the CIRANO Institute.

+1.5%

Assets held in registered form earn 1.5% more after tax than the same assets in non-registered form

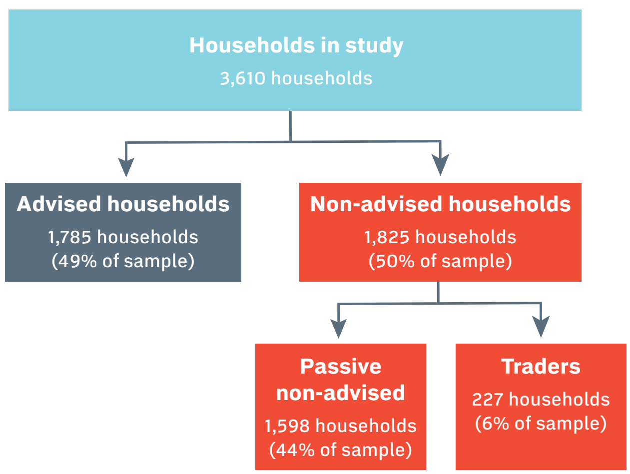
[5] Ipsos Reid, *Canadians and Financial Advice Study*, 2011.
[6] Department of Finance Canada, *Statistics on RPP/RRSP Participation and Savings*, March 31, 2010.

Econometric Research

The CIRANO researchers take the study of financial advice to a new level by using econometric modelling[7] and a robust sample of Canadian households.

SURVEY AND METHODOLOGY

A key feature of the CIRANO research[8] is the depth and quality of its underlying data – the largest and most extensive database yet developed in Canada for this purpose. An initial survey was conducted by Ipsos Reid in December 2010, and a follow-up survey was completed in August 2011. The researchers work with a high-quality final sample of 3,610 households – split into 1,785 advised households and 1,825 non-advised households as shown in the figure below.[9]



A host of socio-economic, demographic and attitudinal information (as presented in the chart to the right) has been collected on each of the respondents so that asset levels could be compared for households that were effectively identical in all respects except for their use of advice.

With this rich database, the researchers are able to single out the effects of advice on asset accumulation after accounting for more than 50 other variables that also influence wealth accumulation.

A Selection of Variables Studied in the CIRANO Research Paper

Demographic Characteristics

- Sex
- Age
- Post-secondary diploma
- Financial literacy
- Risk aversion
- Preference for investing or receiving cash today
- Number of income earners
- Marital status
- Region

Economic Situation

- Household's annual income
- Annual savings
- Source of income
- Employment sector
- Minimum living needs at retirement
- Willingness to save for retirement

Advice Categories

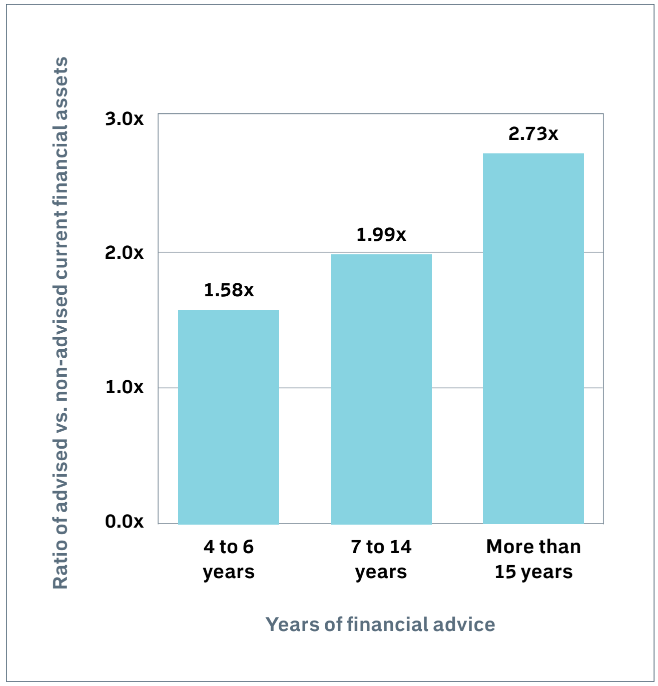
- Level of financial assets required to seek advice
- Tenure of advice

[7] Econometric modelling studies the statistical relationship between different variables, including causal relationships. It aims to isolate the impact of a specific variable when all others have been taken into account.
[8] Montmarquette, Claude and Nathalie Viennot-Briot, *Econometric Models on the Value of Advice of a Financial Advisor*, CIRANO Institute, July 2012. (For a detailed overview of the research paper, refer to "New Evidence on the Value of Financial Advice" by Dr. Jon Cockerline).
[9] The 'Traders' are Non-Advised respondents who agreed with the statements: "I do my own financial planning" and "I am capable of doing my own finances."

The researchers draw four main conclusions from the econometric analysis, as described below.

1 Advice has a positive and significant impact on financial assets after factoring out the impact of close to 50 socio-economic, demographic and attitudinal variables that also affect individual financial assets.

The study reveals that the presence of a financial advisor, when engaged for periods of four to six years, seven to 14 years, and 15 or more years, contributes positively and significantly to the level of assets when the impact of all other variables is factored out. Moreover, the impact on the level of assets is more pronounced the longer the tenure of the advice relationship. The chart below shows financial assets for households that received financial advice over various time periods, as a multiple of the financial assets of households that did not receive advice.



2 The positive effect of advice on wealth accumulation cannot be explained by asset performance alone: the greater savings discipline acquired through advice plays an important role.

The paper finds that advised households save at twice the rate of non-advised house-holds (8.6% compared to 4.3%). The researchers develop a model to explain the savings rate among those who save. They find that financial advice increases the probability that a respondent saves and, among those who do save, it increases the rate of saving. According to these findings, a 1% increase in the 'savings rate' increases the level of assets by 8.7%.

3 Advice positively impacts retirement readiness, even after factoring out the impact of a myriad of other variables.

Having a financial advisor is found to have a strong and significantly positive effect on the level of retirement readiness. Controlling for all other explanatory variables, the researchers show that having a financial advisor increases the probability of a respondent declaring confidence in achieving a comfortable retirement by more than 13% relative to a non-advised respondent.

4 Having advice is an important contributor to levels of trust, satisfaction and confidence in financial advisors — a strong indicator of value.

Controlling for all other explanatory variables, the research study identifies that an advised respondent has a 32% higher probability of declaring trust in financial advisors than a similar non-advised respondent.

Recent International Evidence

In addition to the Canadian research summarized above, there is a growing body of international evidence showing similar results. This section presents research from Australia and the United States that demonstrates that advised investors have higher levels of savings and a greater likelihood of adopting a long-term investment strategy than non-advised investors.

THE MACROECONOMIC BENEFITS OF FINANCIAL ADVICE (AUSTRALIA)

Recent research from KPMG Econtech in Australia demonstrates that the provision of financial advice leads to improved savings behaviour.[10] This, in turn, results in significant benefits to the wider economy, as described below.

KPMG Econtech received data from three major financial advisory networks who are members of the Financial Services Council, including approximately 3.4 million individual accounts for the 2005–06 and 2008–09 financial years.[11] The focus of the study is to estimate the impact of financial advice on savings behaviour.

The Impact of Financial Advice on Savings Behaviour

The study finds that those with a financial advisor save more than those without a financial advisor. Regression analysis shows that an individual who has a financial advisor is estimated to have saved an additional $6,900 over the period from 2005–06 to 2008–09, when compared to similar individuals without a financial advisor. This is equivalent to an additional $1,725 in savings each year for those with a financial advisor compared to those without.

The Impact of Financial Advice on the National Economy

Based on economy-wide modelling[12] to estimate the broader impact of more Australians receiving financial advice, KPMG Econtech finds that the additional saving by individuals receiving financial advice lifts household savings and hence, national savings.
The key economic implications of an additional 5 percent of Australians receiving financial advice are as follows:

[10] KPMG Econtech, Value Proposition of Financial Advisory Networks, January 2011.
[11] The Financial Services Council represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, trustee companies and public trustees. The Council has over 130 members who are responsible for investing more than $1.8 trillion on behalf of 11 million Australians.
[12] This was estimated using KPMG Econtech's MM2 – a fully integrated macro-industry model that can be used to fully capture both the direct and indirect impacts of increases in the level of national saving on the Australian economy over time.

- A 0.3 percent of GDP or $4.2 billion (in 2009–10 dollars) gain in national saving by 2016–17 compared to what would otherwise be the case;
- The higher wealth of Australia due to a rise in national savings leads to less dependence on foreign financing of domestic capital. In the long run, foreign liabilities are lower by approximately 1.3 percent of GDP under the saving scenario; and
- The lower reliance on foreign investment in this scenario could lower the risk premium for investment in Australia, so that gains in business capital are sustained in the longer term.

Those who met with an advisor are more likely to report that they have increased the amount of money they save regularly

THE VALUE OF SEEKING FINANCIAL ADVICE (UNITED STATES)

In addition to the impact financial advice has on individual and national savings, as shown in the Australian research, there are also a number of behavioural benefits to working with an advisor, some of which are explored in a recent paper by Marsden et al.[13]

In *The Value of Seeking Financial Advice*, the authors gather retirement planning data from an online survey at a large American university in October 2009. They examine the data to identify differences in a variety of retirement planning measures between people who have or have not met with a financial advisor.

The study reveals a number of statistically significant relationships, which suggest that meeting with a financial advisor may encourage individuals to engage in more prudent retirement planning activities.

Goal-Related Planning Activities

Those who met with a financial advisor in the past two years are more likely to have established long-term goals and to report that they were working to fulfill them.

They are also more likely to report that they had calculated their financial needs in retirement.

Plan Implementation Outcomes

Those who met with an advisor are more likely to have a supplemental savings account and to have more asset classes across all of their accounts dedicated to retirement.

Responses to the Recent Economic Recession

Those who met with an advisor are more likely to report that they have increased the amount of money they save regularly, increased the level of risk they take with both new and existing investment funds, and increased the time they spend learning about financial topics.

Long-Term Financial Outcomes

Those who met with a financial advisor report greater retirement confidence and significantly higher levels of emergency funds.

[13] Marsden, Zick, and Mayer. The Value of Seeking Financial Advice. Journal of Family and Economic Issues, May 2011.

THE ROLE OF FINANCIAL ADVICE DURING MARKET DOWNTURNS (UNITED STATES)

During the global recession of 2007, investors lost significant amounts of wealth due to impulse investment decisions. Winchester et al examines whether investors with financial advisors are more likely to maintain long-term investment objectives during bear market conditions than those who do not receive advice.[14]

The authors define "investor prudence" as the investor's tendency to maintain investment decisions in the present that support long-term goals. The study models investor prudence as being positively influenced by financial advice, as well as the investor's level of financial knowledge and self-regulation[15], while controlling for factors such as wealth, income, age, race and gender.

The study is based on survey data collected during the summer of 2008 describing consumer attitudes and behaviour in a changing economy. The focus is on individuals who have equity holdings that they can control or direct during a market downturn. Investor prudence is measured by evaluating whether or not the investors rebalanced their portfolios during the market downturn.[16]

The results of the study show that financial advice, along with investor knowledge and self-regulation, has an impact on the probability of being a prudent investor. The two most important influences are: (i) having a written financial plan, and (ii) purchasing financial advice. More specifically, the researchers conclude the following:

- An individual with a written customized financial plan is almost t**wice as likely to rebalance appropriately during a bear market than an investor with no written plan;**

- Investors who purchase financial advice are **more than one-and-a-half times more likely to maintain a long-term investment strategy** compared to investors who do not purchase financial advice.

Financial advice, along with investor knowledge and self-regulation, has an impact on the prob-ability of being a prudent investor

AVOIDING FINANCIAL INVESTMENT ERRORS (UNITED STATES)

Good financial advice is vital to the health of financial markets. Financial decisions are often complex and errors can have serious consequences. Some investors suffer from overconfidence, myopia or simple inertia, which can translate into investment mistakes. The U.S. Department of Labor has observed that after receiving financial advice, pension participants engage in less excessive or poorly timed trading, more adequately diversify their portfolios, and thereby assume less uncompensated risk.

The Department of Labor estimates that advice available prior to the Pension Protection Act (PPA)[17] reduced investment errors by $15 billion annually. It estimates that increased use of financial advice under the PPA will incrementally reduce such mistakes by between $7 billion and $18 billion annually, improving pension participation and societal welfare.[18]

[14] Winchester, Huston and Finke. *Investor Prudence and the Role of Financial Advice*, Journal of Financial Service Professionals, July 2011.
[15] Self-regulation is represented by three measures: (i) having a written, customized financial plan; (ii) having an internal locus of control; and (iii) having an emergency fund.
[16] Rebalancing ensures that the portfolio remains in line with a planned, long-term investment policy rather than letting the asset allocation drift with the market or be impacted by shortsighted behavioural biases.

RETIREMENT INCOME WITH GAMMA-OPTIMIZED PORTFOLIOS (UNITED STATES)

Another recent piece of U.S. research comes from Morningstar, which introduces a concept called "Gamma" – a measure of the value of advice for retirees.[19] Gamma quantifies the additional expected retirement income achieved by an individual investor from making more intelligent financial planning decisions. In other words, it is the return an investor experiences based on optimal financial decision-making.

The authors focus on five important financial planning decisions / techniques, each of which can be thought of as actions and services provided by advisors:

(i) A total wealth framework to determine the optimal asset allocation;

(ii) A dynamic withdrawal strategy;

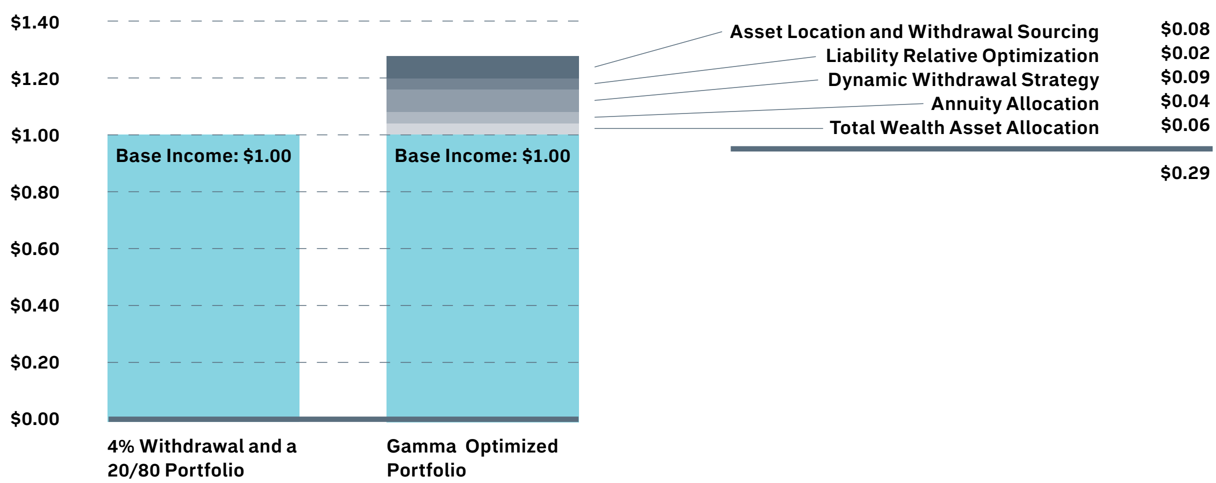
(iii) Incorporating guaranteed income products (i.e., annuities);

(iv) Tax-efficient allocation decisions; and

(v) Portfolio optimization that includes liabilities.

Each of these five Gamma components creates value for retirees and when combined, can be expected to generate 29% more income on a "utility-adjusted" basis using a Gamma-efficient retirement income strategy when compared to the base scenario, as shown in the figure below. This additional income is equivalent to an average annual return increase of +1.82%, representing a significant improvement in portfolio efficiency for a retiree.

More Retirement Income with Gamma-Optimized Portfolios



[17] The Pension Protection Act was signed into law by President Bush in August 2006. The Act made a large number of reforms to U.S. pension plan laws and regulations, with the aim of strengthening the overall pension system.
[18] U.S. Department of Labor, Employee Benefits Security Administration (EBSA), 2011.
[19] Blanchett and Kaplan. Alpha, Beta, and Now…Gamma. Morningstar, September 2012.

Conclusions

As the global economic recovery remains on shaky ground and as traditional pension schemes face increased pressure, Canadian households are faced with an ever greater responsibility for their own financial security in retirement. In most cases, it is vital that this responsibility be met with the help of financial advice.

This report has demonstrated that there is a growing body of research, not only from Canada but also from abroad, which points to the clear benefits of obtaining financial advice. IFIC's previous Value of Advice Reports have shown that advised households have substantially higher investible assets than non-advised households, regardless of household income level and age group. The CIRANO research gives more clarity by providing robust econometric evidence that advice has a positive and significant impact on wealth accumulation, even after accounting for a myriad of other socio-economic variables known to affect wealth.

The CIRANO research gives more clarity by providing robust econometric evidence that advice has a positive and significant impact on wealth accumulation

Numerous studies from the United States demonstrate that financial advice leads investors to adopt better long-term investment strategies. In addition to benefiting individuals, the Australian paper shows how financial advice can play a significant role on the wider macroeconomic level. This can only be a good thing for both investors and national governments as they face increased economic and financial challenges.

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About The Investment Funds Institute of Canada

The Investment Funds Institute of Canada (www.ific.ca) is the voice of Canada's investment funds industry. IFIC brings together 150 organizations, including fund managers and distributors, to foster a strong, stable investment sector where investors can realize their financial goals. The organization is proud to have served Canada's mutual fund industry and its investors for more than 50 years.

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