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INNOVA
ASSET MANAGEMENT

INVESTMENT MANAGEMENT INSIGHTS FOR PROFESSIONAL FINANCIAL ADVISERS

MEETING BEST INTEREST DUTY TO CLIENTS REQUIRES MORE THAN FEE FOCUS

Like every profession, financial planners must act in the best interests of their clients. But meeting that legislative and ethical obligation requires more than just a focus on price, it requires a focus on value.

In the current climate, it's no surprise that low product fees have become a proxy for meeting the best interests duty. A royal commission is now revealing widespread fee misconduct following years of campaigns by industry super funds and index fund providers promoting the merits of low-fees.

While investment returns tend to be variable and unpredictable, investment fees are a constant. A fee increase of just 0.5 per cent can cost a typical full-time worker about 12 per cent of their balance (or $100,000) by the time they reach retirement, based on Productivity Commission **modelling**. Some evidence even suggests that high fee funds are correlated with low performance.

For example, the royal commission recently revealed that certain AMP superannuation funds charged fees that were so high, investors in the cash investment option actually lost money. It **prompted** the firm to cut fees and refund $5 million to around 12,500 affected customers.

Any financial planner who recommended such a product would clearly not be acting in the best interests of their clients (fortunately, few product fees are priced so scandalously).

FEES ARE IMPORTANT BUT NOT EVERYTHING

Nonetheless, we regularly see planners differentiate between very different products because the fees differ by just a few basis points, regardless of how the full suite of product characteristics meets the needs of clients. A lack of adequate tools that make it easy to make a genuine broader best interests assessment is part of the problem. Some advisers also think it ticks the best interests compliance box.

But ASIC specifically acknowledges that higher-fee products can satisfy the adviser's best interest duty.

Regulatory guide 175 gives a specific example of a client holding a portfolio through a platform, which produces consolidated reporting they find difficult to understand. They are prepared to pay more for better quality reporting if they feel it delivers value. They accept their adviser's recommendation to switch to another platform, which charges 0.1% higher fees, because they prefer its reporting.

"In this scenario, we would consider that a reasonable advice provider would believe that the client is likely to be in a better position if the client follows the advice," ASIC's guide says. "The advice provider has complied with the best interests duty."

This is an example of the difference between price and value. Knowing the difference is a critical skill, not just in financial planning, but in life.

INCONSISTENT FEE DISCLOSURE

Worse, the way price is disclosed across the industry is inconsistent. Indirect investment management costs have sometimes been ignored altogether, according to the Productivity Commission's recent **draft super report**.

The corporate regulator has spent years attempting to improve the situation. ASIC's first draft of **Regulatory Guide 97** (Disclosing fees and costs in PDSs and periodic statements) was released in December 2014 and implemented by September 2017. It requires funds to disclose all investment fees and costs on a look-through basis, which has raised disclosed fees across the industry.

For example, the top-performing balanced super fund last financial year, **HostPlus**, now discloses an indirect cost ratio of up to 1.15 per cent (depending on the investment option) in addition to investment and administration fees. These indirect costs have always been part of funds but not always disclosed.

Many sections of the industry oppose the RG97 requirement because they fear it will encourage funds to shy away from higher-fee investments such as infrastructure. However, this simply exposes the myopic focus on fees to the detriment of investment goals and outcomes.

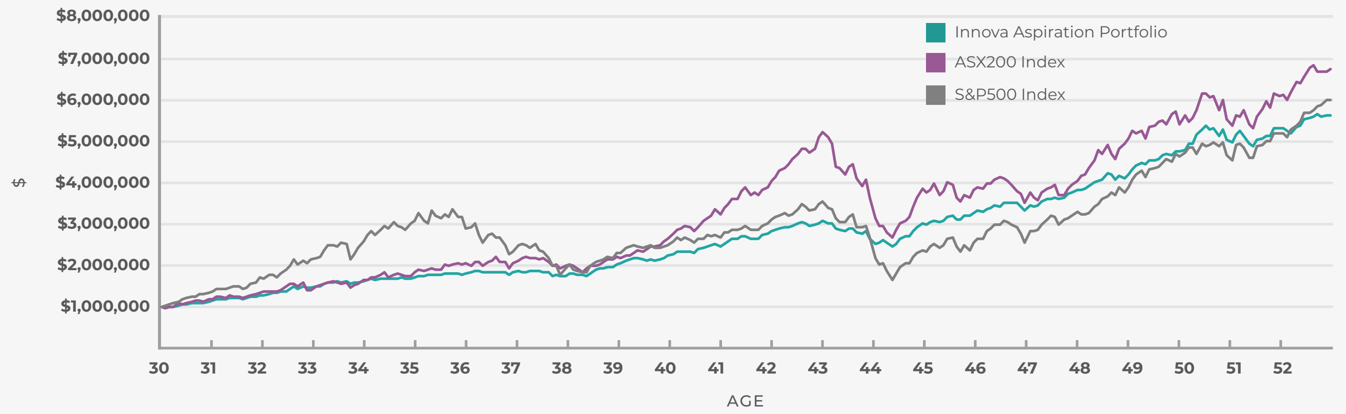
LOWER FEES DON'T ALWAYS DELIVER THE BEST RESULT

Innova's investment funds are highly competitively priced and built to specifically help financial planners fulfil their clients' goals. Investors have a wide range of goals and many concerns but risk is a central consideration for all investors alongside returns.

We have run three simulations ranking the S&P/ASX200, the S&P 500 and the Innova Aspiration portfolio.

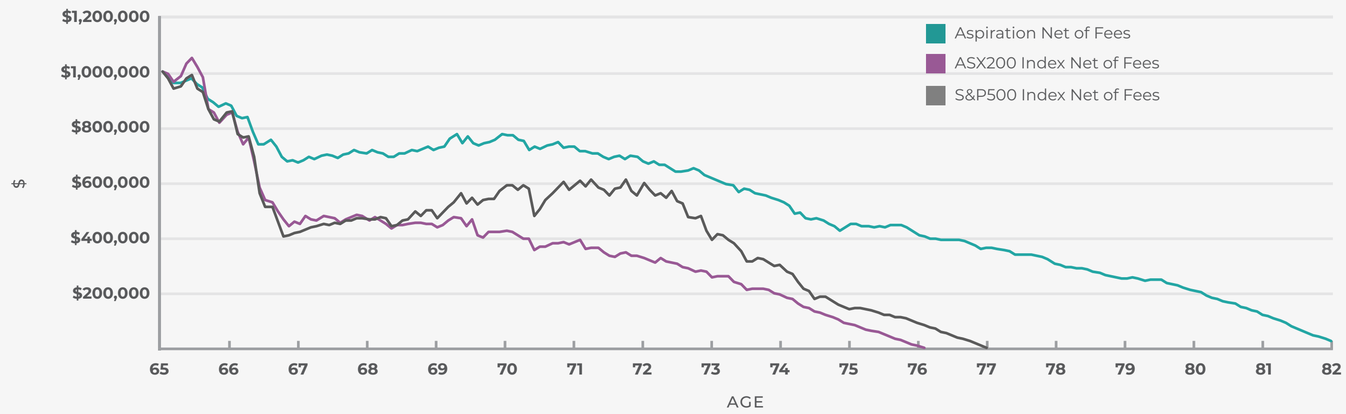
The first scenario shows how an investor with a long-term time horizon (20-plus years) may benefit from an investment in a low-fee index equity fund. The Innova Aspiration portfolio, which has a higher fee, still performs competitively but offers a smoother ride that may suit more risk-averse investors.

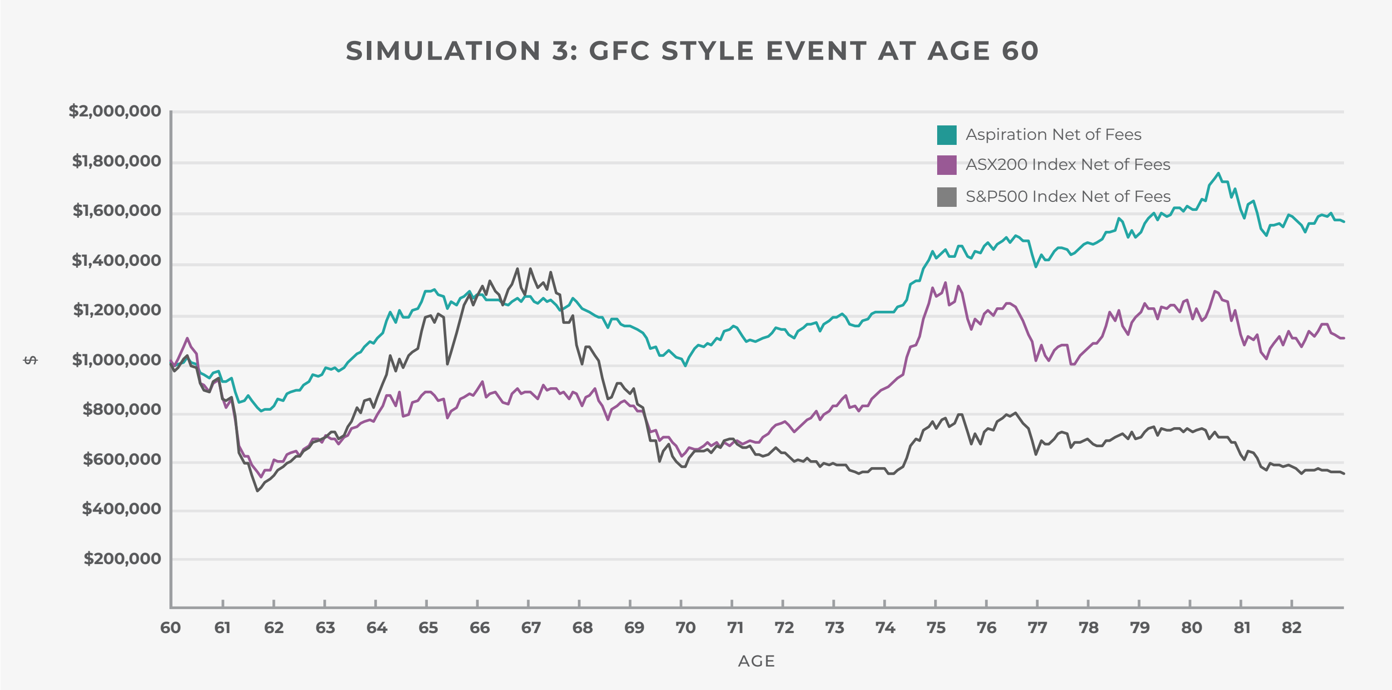
SIMULATION 1: 35 YEAR OLD WITH LONG HORIZON UNTIL RETIREMENT



The second scenario – when a GFC style event hits – shows this in action. In this case, managing risk is much more important than simply choosing a low-cost investment option. Many investors approaching retirement may be better suited in an even lower risk portfolio.

SIMULATION 2: GFC STYLE EVENT AT AGE 65





The third scenario shows the impact of a GFC style event that strikes five years before retirement, underlining why the price of risk management can be more valuable than the cost saved in lower fee investment options. It all comes down to the needs of the client.

While fee levels are an important consideration when making investment recommendations, they shouldn't become a proxy for meeting the best interests duty, or clients will inevitably be left short-changed.

Contact Innova Asset Management for further information about our goals-based investment approach.

Dan Miles
Managing Director & Co-Chief Investment Officer

Dan miles is the Managing Director & Co-Chief Investment Officer of Innova Asset Management. Innova is a boutique risk-focused portfolio manager that has been managing client portfolios for 8 years. Innova was founded on the principles of providing robust and research-intensive insights to help investors meet their financial goals. The firm focuses on managing the multi-faceted nature of investment risks for clients.

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