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ADVISOR SYMPOSIUM

MARCH 12–14, 2018

THE ISLAND HOTEL

NEWPORT BEACH

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The Misguided Beliefs of Financial Advisors

Financial Advisors

» Households rely extensively on financial advisors to guide their investment decisions (ICI 2013, Canadian Securities Administrators 2012):

- 53% of households owning mutual funds in the U.S. held funds purchased through financial advisors
- Out of $876 billion of retail investment assets in Canada, 80% of assets managed by advisors

Cost and Quality of Advice

- Recent research raises concerns about the cost and quality of advice:
  - Many investors paying 1.5% to 2.5% of assets per year for advice and management
    - *Compounds to 15% to 25% reduction in retirement assets over 30-year horizon*
  - The Mullainathan, Nöth, and Schoar (2012) audit study: *"Advisers encourage chasing returns, push for actively managed funds, and even actively push them on auditors who begin with a well-diversified low fee portfolio."*

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Impediments to Low-Cost Advice

- Focus has remained on conflicts of interest as explanation for high-cost and low-quality advice
  - Retail financial advisors often compensated through commissions on the products they sell
  - POLICY CHANGES: U.K.'s and Australia's bans on commission-based compensation
- We investigate an alternative explanation with starkly different policy implications: misguided beliefs
  - Advisors pursue active management and chase returns in high-cost funds because they sincerely believe those strategies improve returns

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Our Paper

» Our Approach: Detailed data on advised accounts in Canada affords unique opportunity to compare advisors' own trades to their clients' trades

» Our Findings:

1. Clients and advisors both underdiversify, chase returns, and prefer higher-cost, actively managed funds; they earn similar net returns even after fees and rebates
2. An advisor's own behavior is a strong predictor of his clients' behavior
3. Advisors show similar trading patterns after they stop advising clients

➢ Differences in advisors' personal beliefs drive meaningful variation in client portfolio returns

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Data

Data

- Data from two (independent) Canadian mutual fund dealers
  - More than 3,000 financial advisors and their half a million clients
  - Total AUM = $18.9 billion–over 6% of the MFDA assets
- All holdings, transactions, and fees from 1999 through 2013
- Demographic information for clients and advisors
  - Know Your Client forms: age, risk tolerance, investment horizon, financial knowledge, wealth, income, occupation

Advisor Portfolios

- Three-quarters of the advisors in our sample are also “clients”
  - Able to link advisor to personal portfolio if held at own firm
- Those who are not are typically younger advisors with few clients
- Clients would only see advisors’ portfolios if willingly disclosed
- Advisors pay the same mutual fund fees as clients, but do receive commissions for their own purchases and holdings

Trading Behaviors of Clients and Advisors

Trading Behaviors

1. Turnover: Do clients trade frequently?
   - (Purchases + Sales)/Holdings (Barber and Odean 2000)
2. Active Management: Do clients prefer actively managed funds?
   - Passive = Index and target-date funds
3. Return Chasing: Do clients favor well-performing funds?
   - Rank all funds based on prior one-year return
   - Compute average percentile ranks of funds purchased
4. Underdiversication: Do clients fully diversify? (e.g., home bias)
   - Measure volatility of residual returns vis-a-vis MSCI World

Fees on Mutual Funds Purchased

5. Mutual Fund Fees: Do clients choose cheap or expensive funds?
   - Average management expense ratio (MER) of funds purchased
6. Relative Fees: Cheap or expensive conditional on asset class?
   - Divide funds into 5 asset classes—equity, balanced, fixed income, money market, and alternatives
   - Compute the percentile rank of each fund's MER within its asset class that month

Measures of Behavior: Clients versus Advisors

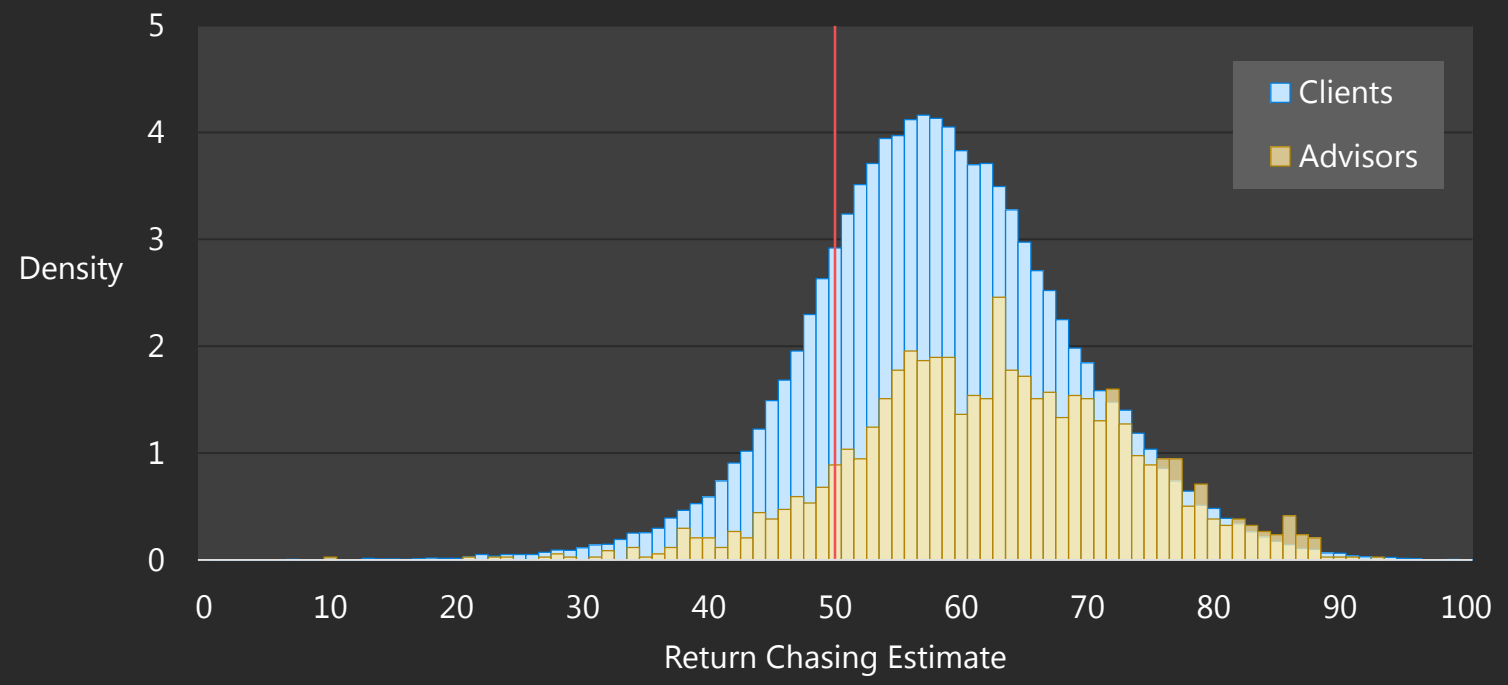
	Clients		Advisors		Difference	
Behavior	Mean	SE	Mean	SE	*t*-value	*N*
Return Chasing	60.3	0.2				2,313
Active Management	98.5	0.1				2,380
Turnover						
Retirement Accounts	30.9	0.7				2,352
Open Accounts	33.7	0.9				1,498
Under Diversification	7.3	0.0				2,402
Fees						
Total MER	2.36	0.01				2,364
Percentile within Asset Class	43.2	0.2				2,361

Measures of Behavior: Clients versus Advisors

	Clients		Advisors		Difference	
Behavior	Mean	SE	Mean	SE	*t*-value	*N*
Return Chasing	60.3	0.2	63.1	0.3	-9.7	2,313
Active Management	98.5	0.1	98.8	0.2	-1.5	2,380
Turnover						
Retirement Accounts	30.9	0.7	38.9	1.3	-6.2	2,352
Open Accounts	33.7	0.9	52.2	1.9	-9.8	1,498
Under Diversification	7.3	0.0	8.1	0.1	-11.1	2,402
Fees						
Total MER	2.36	0.01	2.43	0.01	-6.7	2,364
Percentile within Asset Class	43.2	0.2	45.9	0.3	-10.1	2,361

Do Advisors Encourage Clients to Trade Like Themselves?

Cross-Sectional Variation in Return Chasing



» Considerable variation in behavior across clients.

» Do ① identity of advisor and ② advisor's own behavior explain where clients fall in this distribution?

Explaining Variation in Advisor Recommendations

» Two questions:

1. How important is the identity of the advisor in explaining variation in client behavior?
   - *Does cross-sectional variation in client behavior stem mostly from what clients look like on their KYC forms, or does it matter who you have as an advisor?*
2. If the identity of the advisor matters, do advisors trade the same way as their own clients?
   - *For example, if an advisor chases returns, does he advise his clients to do the same?*

Identification Methodology: Displaced Clients

- Advisors and clients could behave the same way even if advisors provide no input
  - Endogenous matching: clients search and find advisors whose thinking resembles theirs the most

- Solution:
  - Use displaced clients to control for unobserved client-level heterogeneity (i.e., more than just KYC forms!)
  - If the same client is advised by different advisors, we can hold the client identity constant
    - *Focus on forced changes due to advisor leaving firm or business*
    - *Most switches involve transfer of entire "book of business" from one advisor to another*
    - *85% of displaced clients remain at dealer and, conditional on staying,*
    - *87% go to the same new advisor*

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Investor and Advisor Fixed Effects

» R^2s: How much does the identity of the client, that of the advisor, or both explain of the variation in client behavior?

Behavior	Sample: Displaced Clients			
	Client FEs	Advisor FEs	Both FEs	*N*
Return Chasing	5.1%	19.7%	29.1%	12,476
Active Management	8.8%	34.1%	49.0%	13,259
Turnover	7.2%	13.9%	21.9%	22,764
Under Diversification	44.6%	26.1%	63.8%	16,195
Fees				
Total MER	57.0%	34.3%	67.3%	13,161
Percentile within Asset Class	30.7%	29.3%	47.9%	13,076

Explaining Variation in Advisor Recommendations

» Run cross-sectional regression of estimated fixed effects on advisor attributes, including measure of trading behavior in advisor's own portfolio

$$\text{behavior FE}_a = \text{a} + \theta X_a + \text{b} * \text{advisor behavior}_a + \varepsilon_a,$$

» A positive slope means that an advisor trades the same way as his clients

	Basic Model			Two-Way FE Model		
Behavior	Slope	*t*-value	N	Slope	*t*-value	N
Return Chasing	0.24	13.67	1,982	0.29	5.48	592
Active Management	0.29	4.21	2,105	0.26	1.87	624
Turnover	0.16	2.71	2,209	0.22	2.78	739
Under Diversification	0.21	10.50	2,115	0.18	3.96	646
Fees						
Total MER	0.13	5.48	2,073	0.14	2.22	616
Percentile within Asset Class	0.27	15.54	2,056	0.25	4.57	613

Alternative to Beliefs:
Window Dressing

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» Advisor could use his own portfolio to gain his clients' trust
  – If an advisor personally invests in expensive, actively managed funds, the client can perhaps be convinced to do the same

» Also, may experience cognitive dissonance if they invest differently from clients

TEST

» Do advisors behave dierently after they stop advising clients?
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  – Create a matched sample for a pairwise test

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Change in Advisor Behavior After Industry Exit

Behavior	Active Advisors		Post-Career Advisors		Difference		*N*
	EST	SE	EST	SE	EST	SE	
Return Chasing	63.4	1.2	58.3	1.5	-5.1	-2.64	168
Active Management	99.5	0.2	98.6	0.5	-0.9	-1.99	195
Turnover	35.0	4.0	53.4	6.4	18.4	2.74	420
Under Diversification	7.9	0.2	7.2	0.2	-0.6	-2.50	312
Fees							
Total MER	2.47	0.03	2.33	0.04	-0.15	-2.84	184
Percentile within Asset Class	45.8	1.1	46.2	1.4	0.4	0.26	183

Investment Performance

Investment Performance of Clients and Advisors

» Compute alpha from 4-factor model + bond factors

» Account for "rebates" advisors earn on own purchases

		Estimate	*t*-value
Clients	Gross Alpha	-0.69	-0.78
	w/ fees	-3.22	-3.59
Advisors	Gross Alpha	-1.25	-1.29
	w/ fees and rebates	-3.01	-3.07
	Client portfolio plus rebates	-2.26	-2.50
	Hypothetical minus actual	0.75	3.47

» The part of the advisor portfolio that <u>does not</u> overlap with the client portfolio signicantly underperforms the common part

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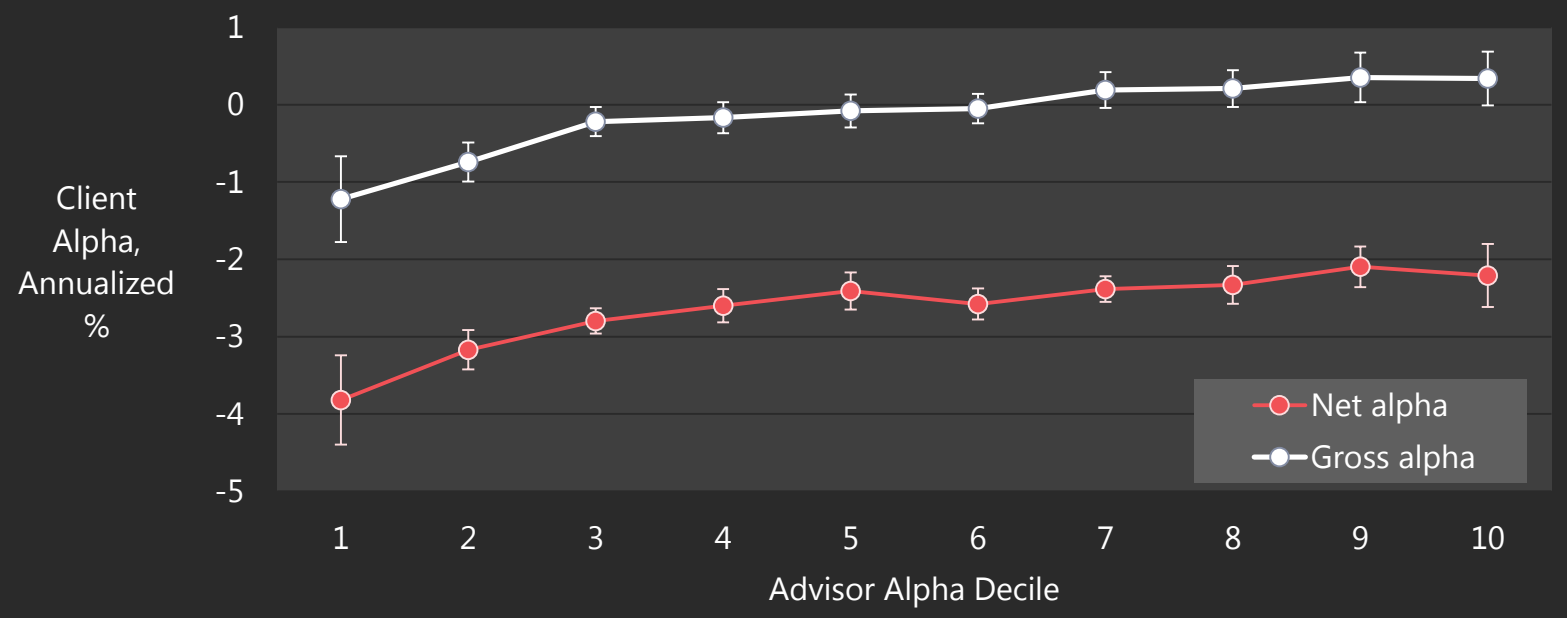
Client Alpha by Advisor Alpha

» Sort advisors into deciles based on alpha of own portfolio

» Compute average alpha among clients of those advisors



» Differences in annualized alphas are 1.6% (gross and net) between the top and the bottom

Conclusions

- Individuals throughout the world turn to financial advisors for guidance
  - 2015 Consumer Financial Literacy Survey: 75% of respondents say that they would "benefit from some advice and answers to everyday financial questions from a professional"
- Despite concerns about conflicts of interest, we document broad similarity in trading of clients and advisors
- Advisors' beliefs—as revealed through their own trades—seem to drive substantial variation in client performance
- Policies aimed at aligning client and advisor interests do not address variation in cost and quality of advice due to differences in advisors' beliefs

Policy Implications

1. Resolving conflicts of interest may reduce cost of advice by less than policymakers hope
   - Many advisors already invest the same whether they are an agent or a principal

2. Addressing the problem of misguided beliefs requires screening or education, perhaps enforced through professional licensing
   - Selection into the profession likely reinforces bias toward active management

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