The Value of Financial Advice

It’s Not (Just) About the Cost

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0 Executive Summary

This paper aims to demonstrate the value of financial advice. To date, there has been considerable focus on reducing the cost of advice to consumers. The authors are concerned that the narrow focus on cost, without reference to value, will lead to incorrect conclusions and exacerbate the current savings crisis in the country.

0.1 Context and Framework Setting

0.1.1 South Africa is experiencing a savings crisis in which current levels of savings are far too low to generate adequate retirement income. Furthermore, amidst a backdrop of growing complexity, the knowledge gap between consumers and the financial issues that affect them continues to grow wider. Advisers therefore play a critical role in the efficient functioning of the financial system.

0.1.2 The paper introduces an Advice-Value Framework as a model within which to assess both the value (i.e. quality) and quantity of advice given to consumers in different situations.

0.1.3 The review of behavioural economic research included in the paper highlights how consumers suffer from poor self-control and struggle to overcome strong preferences for instant gratification. Savings tend to suffer as a result. In addition, research into decision making for others vs. oneself has shown that even financial professionals give better advice to their clients than the financial decisions they make for themselves. This builds a strong case for value-add from advisers.

0.2 Value Measures and Costs

0.2.1 The definition of value has been considered from five perspectives, ranging from Real Value in financial terms to Perceived Value, which takes into account consumers’ perceptions as well as their attitudes to risk.

0.2.2 A section on the cost of advice provision is included to bring attention to the economics of running an adviser practice. The evidence suggests that the financial advice industry is not an excessively well-remunerated industry. An analysis of salaries and hourly costs suggests remuneration is at market-related levels given the qualifications required by advisers under the Financial Advisory and Intermediary Services (FAIS) Act.

0.2.3 The cost of advice to the consumer varies by product type, savings frequency (recurring vs. single premium) and by term. The cost of advice under current commission regulations is briefly included for purposes of comparing the value of advice against the cost.
0.3 Access to Financial Services

0.3.1 Access to financial advice remains a key concern, and the authors believe that insufficient consideration has been given to the trade-off between levels of adviser remuneration and access to advice. Reducing adviser remuneration will force advisers to withdraw from lower-income segments. This is a very real problem faced by most other countries that have introduced strict compliance regimes (which increase the cost of providing advice) and/or reduced commissions. Only by including the added dimension of the value of the advice provided, can appropriate solutions to this area of national concern be found.

0.3.2 No-advice solutions that force the correct behaviour (such as compulsory pension contributions and compulsory preservation) are methods to ensure appropriate financial planning in the absence of access to financial advisers and/or at a lower cost than advisers can offer. The authors are supportive of the National Treasury proposals in this regard. However, one must note that individuals all have unique financial needs and broad-brush rules cannot appropriately deal with the intricacies of individual situations. Only personalised advice can appropriately address the financial needs of individuals. No-advice solutions are certainly part of the solution but cannot ever be the only solution relied upon.

0.4 Discussions of Selected Examples of Advice

0.4.1 The paper works through several common-place examples of advice and the advisory process highlighting where good advice can add value and poor quality advice destroys value. These examples are not intended to be an exhaustive list of all the relevant issues but serve as applications of the Advice-Value Framework developed earlier. The examples show that the Real Value Added of good advice can be many times greater than the cost of that advice. Thus, in some instances, it is more important to focus on the access to good quality advice than the cost of advice.

0.4.2 The examples prove that one only needs to get a few simple, good pieces of advice at the right time (critical decision points) for it to add a significant amount of value. The most important, simple pieces of advice are:

- start to save early and save an adequate amount,
- pick an asset allocation appropriate to one’s savings term and financial objectives,
- stick to one’s plans without panicking after a market correction in the middle of a long-term investment, and
- preserve one’s accumulated retirement savings on any changes in jobs during working life.

0.4.3 Getting these simple things right will mean the difference between financial independence and financial disappointment.
0.5 Conclusion

0.5.1 While focus on the fact that excessive costs can erode savings is necessary, this paper makes the case for holistically considering the cost of advice to consumers, the cost incurred by advisers in providing (compliant) advice and the value generated for consumers from the advice given. Furthermore, the paper stresses that the trade-offs between levels of adviser remuneration and access to advice need to be factored into all debates on the subject of costs in the financial sector.

0.5.2 Hopefully the issues raised in this paper will contribute positively to finding solutions for better access and better quality advice for all consumers.
1 Introduction

1.1 Objective of the Paper

1.1.1 There has been much debate and critique about the cost of financial advice in South Africa. Attention has been focused on reducing the cost of advice to the consumer (i.e. the quantum of commission) and in improving the quality of financial advice. However, there has seldom been any reference to the actual value of the advice.

1.1.2 Only by reviewing the cost to the consumer, the expense incurred in providing advice and the value of the advice to the consumer all together, can one design a regulatory regime that protects consumers and promotes both the well-being of consumers and the economy.

1.1.3 The main purpose of this paper is to bring balance to the debate by placing a value on financial advice using actuarial and other techniques.

1.1.4 Interestingly there appears to be little rigorous research on this critical subject either locally or internationally.

The cost of financial advice has little meaning unless it is evaluated together with the value to the consumer of that advice.

1.2 Scope of the Paper

1.2.1 The paper deals with issues related to the value of financial advice to individuals in South Africa. Financial advice refers to the provision of information and recommendations with regard to an individual’s investment, insurance and debt-management needs. In particular, the paper focuses on intermediated advice (i.e. face-to-face advice), but the research does make comments on direct and no-advice solutions.

1.2.2 The focus has generally (but not exclusively) been on advice related to investment products.

1.2.3 Value is generally assessed in financial terms in the paper. The paper does not attempt to value non-quantifiable components or outcomes of advice (such as peace of mind).

1.2.4 The actual state of the quality of advice and the competence of advisers in South Africa is outside the scope of this paper.

1.3 Structure of the Paper

1.3.1 The paper begins by setting the context of the country’s troubled savings climate. It then establishes a framework for assessing the value of financial advice. This is followed by a review of some of the traditional economic models and some of the newer behavioural economic thinking with respect to the consumption and savings patterns of individuals. In this context it then defines appropriate measures of ‘value’.

1.3.2 The paper then covers the costs incurred in providing advice to consumers and then, for completeness, briefly documents the cost of advice to consumers.
1.3.3 The trade-off between access to financial advice and the cost of advice is also covered in the paper.

1.3.4 The latter part of the paper demonstrates examples of how good advice can add value and how poor-quality advice can destroy value.

1.3.5 Finally, it provides recommendations for improving the status quo based on the conclusions of the research.

1.4 Acknowledgements

1.4.1 This research could not have been completed without the assistance of numerous individuals and organisations. The authors would like to acknowledge the comments, suggestions and data supplied by, amongst others: Abubaker Addae, Alexander Forbes, Rowan Burger, John Bryant, Peter de Beyer, Peter Dempsey, Tracy Dunley-Owen, Charl du Plessis, Johann Els, Mike Harper, Rian le Roux, Rosemary Lightbody, Masthead, Peter McGregor, Old Mutual, Rob Rusconi, Cheryl Small, Soshan Soobramoney, Jennifer Stromfors, Greg Torr and Etienne Venter.
2 Context

This section provides evidence of the savings crisis in South Africa. Lack of preservation of retirement savings is a major contributing factor to this. This contextual issue suggests that interventions such as financial advice can improve individuals’ retirement prospects.

2.1 South Africa’s Savings Crisis

2.1.1 Over the past decade South Africa has experienced strong economic growth. Real GDP growth has averaged 3.5% p.a. over the ten years to June 2007, rising from an average real growth of 1.8% p.a. in the ten years prior. As is shown in Figure 1, households have experienced accelerating real income over the last decade.

![Figure 1 - Household Real Income and Spending Growth](Source: SARB, OMIGSA Macro Strategy Team)

2.1.2 However, household spending has risen faster than income. This is shown more clearly in Figure 2 which enlarges the trend since 1980.
2.1.3 The net effect of this increased spending as a percentage of post tax income is a drop-off in the net personal savings ratio. In fact, as Figure 3 demonstrates, net personal savings rates\(^1\) have actually fallen to below zero.

\[\text{Figure 3 - Net Personal Savings Ratio} \]
(Source: SARB, OMIGSA Macro Strategy Team)

2.1.4 This ratio measures savings less borrowings of individuals. On a gross basis consumers are saving, but they are saving at a lower rate and borrowing at an increasing level than in the past, leading to a negative net savings rate. While this ratio is cause for concern, it is more appropriate to look at gross savings or flows into financial assets to get a sense of the savings crisis in South Africa.

\[^1\] Personal savings as a percentage of disposable income (note ‘disposable income’ is the same as ‘after-tax income’)
2.1.5 The decline in net flows into financial assets\(^2\) as a percentage of after-tax income over the last 20 years is pertinent. In this period of booming real consumption expenditure (refer Figure 2) South Africans have been saving less of their income than they did in the past. This is reflected in Figure 4 below.

![Figure 4 - Flows to Financial Assets as a Percentage of Disposable Income](Source: SARB, OMIGSA Macro Strategy Team)

2.1.6 These flows can be further split into contractual savings (retirement funds and life insurance policies), deposits and other non-contractual financial assets (the remaining savings including unit trust investments).

![Figure 5 - Breakdown of Flows to Financial Assets (% of Disposable Income)](Source: SARB, OMIGSA Macro Strategy Team)

2.1.7 The above graph shows how flows into contractual savings vehicles have been declining in South Africa over recent years. Over the last decade, net flows into contractual savings

\(^2\) Inflows less outflows into pension funds, life insurance policies, deposits and unit trust investments.
vehicles have averaged only slightly above 5% of disposable income. These levels are far too low to generate an adequate replacement ratio in retirement.

2.1.8 A simple calculation shows that to retire with a replacement ratio of 50% one needs to save 15% of after-tax (disposable) income for 30 years. If one saves at a lower rate or starts saving too late, the percentage of after-tax income that one needs to save to achieve this replacement ratio increases significantly. To achieve a more desirable 70% replacement ratio one needs to save 16% of after-tax income for 40 years or 20% for approximately 34 years. Other authors (e.g. Rusconi, 2004) have developed other ‘ideal’ figures, all of which are greater than 10% p.a.

2.2 Limited Preservation of Benefits

2.2.1 South Africa’s low savings rate is further exacerbated by the fact that of those few individuals who begin to save for retirement, even fewer go on to preserve their accumulated savings on withdrawal from retirement funds (e.g. when changing employers). Preservation occurs when individuals do not spend their withdrawal benefits on leaving a retirement fund, but transfer them to a new retirement fund (either their new employer’s retirement fund or a preservation or retirement annuity fund).

2.2.2 The quantum of retirement benefits obviously depends on the level of contributions to a fund and the investment return earned on the fund assets. However, members’ ultimate retirement benefits are heavily affected by member behaviour, particularly in defined contribution funds.

2.2.3 National Treasury, through the Social Security and Retirement Reform process, has recognised that a major reason for insufficient retirement benefits in the formal sector is leakage from the system, i.e. poor ‘early-leaver’ benefits, multiple withdrawals of accumulated funds through ‘job-hopping’ and members withdrawing retirement savings to fund periods of unemployment (National Treasury, 2004).

2.2.4 The Alexander Forbes Member Watch survey (Issue 1, 2006) produced alarming evidence of the lack of preservation of retirement fund benefits in South Africa. The percentage of retirement benefits that are preserved on withdrawal by low-income earners is well below 10%, with the preservation rate for high-income earners only reaching 50% at the higher age groups. Figure 6 and Figure 7 below show this in detail.
2.2.5 The long-term impact of such low levels of preservation on withdrawal is concerning. Using a benefit design that targets a replacement ratio of 70% of salary on retirement, Alexander Forbes calculates that the expected replacement ratio for fund members (based on actual experience of withdrawal and preservation rates) could be as low as 16% for low-income earners and 24% for higher-income members.

2.2.6 These numbers strongly support the argument for compulsory preservation, which will result in significantly higher replacement ratios for retiring members. At the same time it is necessary to recognise that some South Africans use their retirement savings to fund periods of unemployment and so compulsory preservation is not without controversy.

2.2.7 Exiting retirement fund members need to better understand the potential value-destroying impacts of their financial behaviour. The education of retirement fund members on financial matters is important. Facilitating members’ access to financial advice can be a valuable means to improve member understanding. Financial advisers play an important role in educating members on the long-term financial value of saving, preservation of contractual
savings, the appropriate investment vehicles available, and any associated tax benefits where applicable.

2.3 Summary

2.3.1 The inadequate levels of savings, coupled with low levels of preservation of retirement benefits, mean there is a significant opportunity for financial advice to add value. One of the key roles of an adviser is to perform a financial needs analysis for clients which will assess (amongst other things) an individual's savings gap. As discussed in Section 4, most consumers tend to have a strong preference for current consumption (instant gratification) over saving for future needs.

2.3.2 Receiving appropriate financial advice at the earliest possible time is critical for individuals to understand how much they need to save to achieve even moderate savings objectives.

2.3.3 While consulting an adviser is not the only way for individuals to understand their savings gaps, and hence to see an improvement in the savings and preservation ratios shown above, the role that advisers can play is crucial in increasing South Africans’ contractual savings and improving net personal savings rates.

2.3.4 This context of the crisis in the level of retirement savings in South Africa is important for assessing the value of financial advice to individuals and the economy later in the paper.

Having set the scene with some concerns about the level of individual savings in South Africa, the next section develops a framework to understand the relationship between the provision of financial advice and its value.
3 The Advice-Value Framework

This section develops a framework for representing the match between the level of advice received and its value. This is referred to as the Advice-Value Framework for the remainder of the document.

3.1 Basic Framework Development

3.1.1 Consider the continuum of the quantum of advice a consumer receives. Some consumers will accept the assistance of a financial adviser, who will perform a full needs analysis, and provide a full service for the consumer’s financial needs. At the other extreme is the individual who does not receive financial advice. This continuum is plotted on the vertical axis (Figure 8).

3.1.2 On the horizontal axis the relative value of the advice/action taken by the consumer is illustrated. Value in this context would be some sort of financial value or utility value (see Section 5). To the left, the consumer experiences negative value. At the axis intersection the consumer receives zero value. To the right of the vertical axis, the consumer receives positive value.

![Figure 8 – The Advice-Value Framework](image)

3.1.3 The quadrants in Figure 8 are labelled as follows:
- **Quadrant 1 (top right):** This is a desirable position. The consumer receives advice and it creates value.
- **Quadrant 2 (bottom right):** This is also a desirable position. The consumer does not receive advice, but as a result of their own actions (based on some level of financial literacy) and/or the actions forced upon them by the environment, they experience a positive value.
• **Quadrant 3 (bottom left):** This is not a desirable position. Consumers are either self-servicing, or take no action with respect to their financial affairs, and this harms their financial well-being.

• **Quadrant 4 (top left):** This is also not a desirable position. The consumer receives advice and pays for it, but the advice is detrimental to their financial well-being.

### 3.2 Application of the Framework

#### 3.2.1 In the advice zone (above the horizontal axis), advice can either be good (generating a positive value), or bad (causing a negative value change) for the consumer. There is, however, a zone where the advice is positive in value, but this value is less than the cost of advice. Thus, on a net basis the consumer’s financial well-being is negatively impacted. This is plotted in Quadrant 4. Reducing commission to lower the cost of advice would be one way to shift the experience to Quadrant 1.

#### 3.2.2 In the no-advice zone (below the horizontal axis), there is a differentiation between consumers who purchase financial products of their own accord, without having been advised to do so by an adviser. For instance, a consumer who buys a car on credit will not receive much advice (beyond the National Credit Act requirements), but will consume a financial product. This action can lead to positive value or negative value. One would presume that the purchase of a car on credit would lead to a positive (utility) value, as the consumer enjoys the use of the car to a ‘value’ that exceeds the cost of the car, plus the cost of the financing (Quadrant 2). A counter-example might be a consumer financing non-essential goods through a loan shark at extortionist interest rates. In this case the consumer does not receive any advice and the utility of the consumption could be lower than the cost of the debt which might ultimately be many times the value of consumption (Quadrant 3).

#### 3.2.3 The consumption experience for disintermediated products (e.g. direct marketing products) would be plotted somewhere in Quadrant 1 or Quadrant 4, just above the no-advice level, as consumers would receive some ‘advice’ even if it is just the information in the marketing material.

#### 3.2.4 Some consumers do not take any action and there are financial consequences of this lack of action, for example insufficient savings or inadequate short-term insurance. This outcome is plotted in Quadrant 4.

#### 3.2.5 The outcomes of consumers who do not receive advice, but nonetheless are financially better off are plotted in Quadrant 2. This would best be illustrated by a National Savings Fund, whereby the consumer does not get advice, does not take any voluntary action, but due to the system rules, actually receives positive value.
3.2.6 Figure 9 summarises these scenarios.

![Figure 9 - Scenarios Plotted on Advice-Value Framework]

3.2.7 The objectives of the financial system are (see Figure 10):

- To eradicate poor advice causing negative value, so shifting individuals’ advice experience from Quadrant 4 to Quadrant 1. This is one of the objectives of the Financial Advisory and Intermediary Services (FAIS) Act.

- To reduce the cost of advice by reducing commission. This can move outcomes from Quadrant 4 to Quadrant 1 or move outcomes already in Quadrant 1 further to the right. However, reducing commission can also lead to reduced access to financial advice which will result in some consumers’ outcomes shifting from Quadrant 1 and 4 (receiving advice) to Quadrants 2 and 3 (no longer receiving advice). A shift to Quadrant 2 is more desirable than a shift to Quadrant 3, but because of poor financial literacy and behavioural problems experienced by individuals (discussed in detail later in the paper), Quadrant 3 is more likely.

- To move self-serving consumers in Quadrant 3 either to receive good advice in Quadrant 1 by increasing their access to financial advice, or to get positive value from their self-service (Quadrant 2).

- To move no-action consumers in Quadrant 3 from a circumstance of negative consequences, either to get good advice in Quadrant 1 (access), or to change the environment so that their inaction still has positive value (Quadrant 2). This is one of the objectives expressed by National Treasury in their Retirement Fund Reform paper (2004). Notably compulsory participation in retirement funds and compulsory preservation of retirement fund benefits.
3.2.8 It may be attractive to suggest that all financial service experiences should be in Quadrant 2. There is no reduction in value due to advice fees and the consumers experience is positive in value. However, this is unlikely to be possible to achieve for all consumers for any type of financial service. Individual needs are so diverse and unique that any environmental change aimed at pushing consumers’ experience into Quadrant 2 will inevitably have unintended consequences for some consumers. The environment can be constructed to benefit the majority of people, but individual advice (i.e. Quadrant 1) is essential to provide additional value, or to ensure Quadrant 3 consumer experiences are moved to Quadrant 1. Environmental and structural changes will be a part of the solution but they cannot be relied on to be the only solution.

This section has developed the Advice-Value Framework to understand whether advice is positive or negative in value, and whether no advice produces positive or negative value. The balance of the paper refers to examples on the Advice-Value Framework. Measures of value are developed later in Section 5.
4 Summary of Relevant Economic Research

This section reviews some economic models of how consumption varies over an individual's lifetime, as well as the tendency of consumers to chase instant gratification at the expense of longer-term utility. Behavioural economics research is also discussed in some detail. Finally, the value that advisers and financial products can add in helping consumers manage their financial affairs, and particularly their lifetime consumption, more appropriately is discussed.

4.1 Review of Economic Models and Consumer Psychology

4.1.1 Franco Modigliani's 'Life-cycle Hypothesis' is an economic model that explains the consumption and savings behaviour of individuals. Modigliani argued that consumption depends on a person's lifetime income. He showed how consumers can spread their income, and hence their consumption, smoothly over their lifetime, using savings and borrowing. Modigliani argued that through smoothing income and consumption over their lifetime, consumers can enjoy a stable level of utility throughout their lives as opposed to experiencing periods of very high utility (happy times) followed by periods of very low utility (disillusioned times).

4.1.2 The generally accepted life stage model of financial planning is one where consumers are net borrowers early in their careers, accumulate wealth during the mid- to latter parts of their careers and then consume this wealth during their retirement years. This model is based on this concept of smoothing consumption, and hence utility, with reference to one's expected lifetime income.

4.1.3 However, Modigliani's models (and other economic models such as Milton Friedman's 'Permanent Income Hypothesis') are premised on the faulty assumption that consumers are always rational. This is not the case, and these models have not proved to be accurate reflections of the actual behaviour of consumers (Mankiw, 2007).

4.1.4 More recently behavioural economics has started incorporating psychological factors into economic theories. These allow for the fact that consumers are human beings and often make decisions that are far from rational.

4.1.5 One of the key messages of behavioural economics is that 'even if individuals know what is good for them, they may find it difficult to act accordingly' (Kooreman & Prast, 2007). Most consumers suffer from significant willpower problems. The focus of behavioural economics is to improve the welfare of individuals by mitigating self-control problems and procrastination (Hernstein et al, 1993).

4.1.6 Strong evidence of lack of willpower is also found in the
health domain. Researchers have found that members of gyms who chose flat monthly fee contracts pay up to 70% more than they would if they had chosen to pay per visit. They also found that people delay cancelling their membership for longer than they should due to overconfidence about future attendance (Kooreman & Prast, 2007).

4.1.7 Even consumers who are aware that they under-save (or should go on a diet) might not be able to change their behaviour due to a lack of willpower.

4.1.8 Research by Thaler and Laibson has covered issues of self-control of consumers and preferences for immediate gratification. Interestingly, they found that the illiquidity of an asset can play a role in helping consumers constrain their own future consumption. According to Laibson as explained by Camerer (2002):

‘If people can withdraw money immediately from their assets, as they can with simple savings or checking accounts, they have no way to keep their temptation to over-consume under control. Assets that are less liquid, despite their costly lack of flexibility or even lower yield, may be used as a commitment device for those consumers who at least partially understand their tendency to over-consume.’

4.1.9 Laibson also argued that increased liquidity and access to savings brought about by financial innovation in products ‘may lead to damaging decreases in savings’ (ibid.).

4.1.10 Banks, Blundell and Tanner (1998) have shown that individuals do not manage their lifetime incomes well. They have shown that income and consumption drop sharply as individuals retire because individuals have simply not saved enough for their retirement. They attribute the primary cause of this inadequate savings to poor self-control.

4.2 Research on Methods to Increase Savings

4.2.1 Two very positive lessons from behavioural economics research are that consumers ‘are prepared to accept help because they know their limitations and weaknesses’ and that regulatory policies that are inexpensive and do not create market distortions, can be successfully implemented (Kooreman & Prast, 2007). A mandatory pension contribution is a particular intervention recommended by much of the behavioural economics literature. Penalties on early withdrawal from investments are also suggested to mitigate the effects of poor self-control problems (Kooreman & Prast, 2007; Camerer, 2003).

4.2.2 Researchers have suggested two interesting ways to encourage consumers to save more. The first is through making use of ‘inertia’ or the ‘path of least resistance’. Mankiw (2007) cited studies showing that employee retirement savings at companies where employees are automatically enrolled into the 401(k) plan\(^3\) (employees need to complete a form to opt out) are significantly higher than employee retirement savings at companies where employees have to positively elect to join the 401(k) plan. This ‘inertia’ is also prevalent in the behaviour of South African consumers. National Treasury’s plan to introduce

\(^3\) A tax-efficient US retirement savings vehicle available to many employees via their employers.
compulsory pension savings is a powerful step that will effectively legislate this ‘path of the least resistance’.

4.2.3 The second approach is to find ways to assist people in controlling their desires for instant gratification. The ‘Save More Tomorrow™’ programme advocated by economist Richard Thaler is a particularly interesting idea (Thaler and Benartzi, 2003). The essence of this programme is that people commit in advance to put a portion of their future salary increases into a retirement savings account. When signing up for the programme there is no sacrifice of current consumption for higher savings, only a commitment to extra future savings funded out of future salary increases (reduced future consumption in real terms).

4.2.4 Thaler and Benartzi implemented this programme in several companies. They found that a high proportion (78%) of employees took up the plan and, more importantly, that the vast majority (80%) of those who signed up for the programme remained in it until at least the fourth pay increase. The average savings rates of the participants in the programme rose from 3.5% to 13.6% over the course of 40 months.

4.3 The Role Advisers Can Play

4.3.1 Another interesting field of research is that of decision making for oneself vs. decision making for others. Timura (2006) and Hibbing & Alford (2005) explain that professionals are more protective of their clients’ interests and more thorough in decision making for their clients than if they were making decisions for themselves.

4.3.2 This body of evidence suggests that even professional investors are better at making investment decisions for others than they are for themselves. Timura concludes that ‘there should be observable advantage to having someone else decide investment issues, not because that someone else is smarter or more experienced, but simply because that person is someone else.’

4.3.3 Thus, given the strong natural preference displayed by most consumers for immediate consumption rather than deferring consumption and saving more, coupled with the fact that even investment professionals make better decisions for others than for themselves, there is clearly a very strong value-add that financial advisers can offer.

4.3.4 While much of the research has been conducted using US consumer data, South African consumers are known to exhibit similar preferences for immediate consumption at the expense of savings. The graphs shown earlier in this paper analysing savings rates in South Africa show clearly how consumption has been growing faster than savings in South Africa over a long period of time.

4.3.5 The role of financial advisers in highlighting savings gaps, offering individuals appropriate products (often with products with limited and/or costly access to the funds before retirement being entirely appropriate) and motivating or even compelling consumers to start saving more now is a crucial role and adds significant value.
4.4 Illustration on the Advice-Value Framework

4.4.1 These concepts can be shown on the Advice-Value Framework introduced earlier.

4.4.2 Advisers can move customers upwards and to the right on the Advice-Value Framework (towards Quadrant 1) by helping them overcome their tendency to under-save (over-consume) and by making better decisions than consumers could make by themselves (decision-making for others vs. self).

4.4.3 In addition, non-adviser initiated interventions, such as compulsory retirement savings and making use of other positive ‘inertia’ models, can also help to prevent consumers from chasing immediate gratification at the expense of longer-term savings, and thereby moving consumers into Quadrant 2 on the Advice-Value Framework.

![Advice-Value Framework Diagram]

Figure 11 - Interventions Creating Improvements on Advice-Value Framework

This section has confirmed what many financial industry practitioners have long known – that consumers do not naturally do the right thing when it comes to financial planning. They suffer from poor self-control and struggle to overcome strong preferences for instant gratification. Coupled with the fact that decisions made for others are generally superior to decisions made for one-self, this section has shown the high potential for value-add from advisers.
5 Measures of the Value of Advice

It is sometimes difficult to define whether a specific set of actions or advice is positive in value or not. In this section five measures of value are defined. These measures are then used later in the paper in examples and case studies to illustrate the impact of advice or lack of action.

5.1 Real Value

5.1.1 Assume that money has only one value: that is, it buys goods for consumption. That consumption is either immediate or delayed. If delayed, there is a period of saving/investment before consumption. In the work of Kahneman & Riepe (1998) this is described as the ‘normative analysis’ which is the ‘rational solution to the decision problem’.

5.1.2 It is necessary to draw a distinction between an amount specified in nominal terms and an amount specified in real terms. ‘Nominal’ refers to the simple addition of amounts without regard for their timing or any inflation/interest attached to them. ‘Real’ takes account of the timing of the cash flow. Comparing nominal amounts does not lead to sensible conclusions, while comparing real values is an appropriate financial measurement. For example, R100 in cash in your hand now is not the same as R100 promised to you in 50 years time. At 5% inflation, the R100 that you hold in your hand for 50 years will buy you the equivalent of R8 worth of goods in 2057. Thus, the nominal value is R100, but the real value is R8.

5.1.3 Real Value is computed as the financial impact on an individual in real monetary terms, either immediately or at some point in the future. Real Value Added of any advice is the increase (or decrease) in the individual’s wealth because of the decision and action generated by that advice. Hence, Real Value Added will be the Real Value generated by one set of actions minus the Real Value of another set of actions (or inaction). And finally, the Net Real Value Added is the Real Value Added less the cost of the advice.

5.1.4 So for instance, the decision to invest R100 now, instead of consuming it, is evaluated.

5.1.5 Option 1: Immediate consumption:
- The consumer’s net worth now is R100 in real terms and in nominal terms.
- If he consumes the R100, he receives R100 worth of ‘gratification’. In 10 years’ time he has R0 and therefore no future consumption or ‘gratification’.
- Total lifetime gratification is R100 (all now and none in the future)

5.1.6 Option 2: Investment:
- If the consumer invests the R100 at 10% return per annum, then he has no ‘gratification’ now, but in 10 years time he will have R259 and will then spend this on consumption and have R259 worth of ‘gratification’.
- However, lifetime gratification is R259 (none now and R259 in 10 years).

5.1.7 Inflation has to be taken into account. This is a key element of financial literacy that is required to understand consumption behaviour. If inflation is 5% p.a., then the R259 available for consumption in 10 years’ time would only buy the equivalent of R159 in today’s terms, i.e. it is R259 in nominal terms, but only R159 in real terms.
5.1.8 This means that the individual has received R59 of Real Value Added by his decision to save rather than consume, i.e. R159 Real Value under the investment option, minus R100 under the spend option. In the context of advice, the adviser who convinced the individual to delay consumption might have charged R10 for the service. The advice to delay consumption has thus resulted in a Net Real Value Added of R49 (Real Value Added - Cost of Advice).

5.1.9 Debate about this value will centre on the assumptions used and the variability allowed for in determining this value, e.g. the expected future investment returns on a portfolio of assets. The conclusion will then be that if the Net Real Value Added is greater than zero, then this advice will be plotted in Quadrant 1 of the Advice-Value Framework.

5.2 Community Value

5.2.1 Community Value is related to the aggregate Real Value of the members of the community. Similarly, Community Value Added is the value added by one set of decisions and actions vs. another. Net Community Value Added is the Community Value Added less the cost of advice.

5.2.2 For example, the Real Value to an individual of life insurance is negative:
- If he lives then he is worse off by the premiums paid, i.e. he could consume less because he paid insurance premiums.
- If he dies then he cannot consume the payout anyway so the value is zero.

5.2.3 However, the Community Value relates to others involved. So, an insurance policy with a payout of R100,000 has the following community value:
- Negative since one member (the life assured) of the community is worse off in Real Value by premiums paid, say R1,000.
- Positive because the life assured is still in the community and earning income for the community, or if the member has died, positive because the community receives the sum insured.

5.2.4 If the life assured survives then the Community Value is positive (if the premium < income), but if he dies this year, then the community (being his dependants or other beneficiaries) receive positive value of R100,000 less the value of the lost income of that individual.

5.2.5 So, the advice to purchase life insurance is Real Value negative for the individual, but generates positive Community Value Added.

5.3 Economic Value

5.3.1 As a further extension of the Community Value the impact of a set of actions on the country or economy can be defined. This is not at an individual level but at a macro level. For instance, it is suggested that increased savings (delayed consumption) by individuals generally has a positive Economic Value. The Economic Value is the positive financial impact of savings providing capital for economic development, less the negative impact of delayed consumption.
5.3.2 Similarly, Economic Value Added is defined as the increase in Economic Value due to a decision or action, and Net Economic Value Added is defined as the Economic Value Added after the deduction of costs.

5.4 Perceived Value

5.4.1 Perceived Value extends the concept of Real Value to allow for the consumer’s perceptions, behaviour and the nature of accumulated funds. Perceived Value Added is defined as the increase in Perceived Value due to a set of actions. Net Perceived Value Added is the net of costs equivalent.

5.4.2 It is possible that the mere changing of a string of cash flows into a lump sum has positive Perceived Value to a consumer. For instance, in a stokvel with 12 people each paying in R100 per month for 12 months, each person will receive R1,200 after 12 months to buy some significant item. It adds value to the consumer who would not otherwise save. So the peer pressure mechanism causes delayed consumption. And it often allows the consumer to purchase a durable capital item with her R1,200 savings instead of consuming her R100 per month on non-durable goods (expenses).

5.4.3 Everyone is happy with this despite the fact that the Real Value Added is negative. In this simple example, assuming 5% p.a. inflation, R100 for 12 months in return for R1,200 at the end of the 12 months results in Real Value Added of -R31 or -3% of the nominal cashflow. So the individual is in fact worse off due to the transaction. However she does not feel worse off! So in terms of the Advice-Value Framework, this individual’s experience is plotted to the right of the vertical axis, because her Perceived Value Added is greater than zero even though the Real Value Added is less than zero.

5.4.4 From an advice perspective it is therefore important to assist the individual to identify situations where her Perceived Value Added is positive when the Real Value Added is actually negative and ensure she makes this decision in light of this understanding.

5.4.5 There is another important consideration in Perceived Value. Through the process of providing advice, an adviser can give the consumer a psychological benefit in terms of the trust built up between adviser and consumer. Even if the advice was to do nothing and cost nothing (or created positive value that was completely offset by the cost of advice), the consumer would have received Perceived Value in terms of a feel-good factor. The fact that someone knowledgeable and trustworthy has looked at the consumer’s financial affairs can give the consumer peace of mind. This is similar to the feel-good factor that an individual enjoys after an annual medical check-up where the doctor says there is ‘nothing wrong’. The value of this information is considerable to an individual through the peace of mind it creates.

5.4.6 The counter to this positive Perceived Value is a widely held perception that financial advisers cannot be trusted and provide bad advice. People with this view will move themselves from Quadrant 4 (negative value advice) to Quadrant 2 (do it properly for themselves), or often Quadrant 3 (do nothing or do it badly for themselves). Only an improvement in the general perception of financial advisers will result in more people seeking advice. And only an improvement in the advice given will ensure that more consumers move to Quadrant 1.
5.4.7 Behavioural finance attempts to ‘better understand economic decisions and how they affect market prices, returns and the allocation of resources’ (Wikipedia, 2007). A particular sub-topic is Prospect Theory (Kahneman & Tversky, 1979) which ‘describes how people make choices in situations where they have to decide between alternatives that involve risk’ (Wikipedia, 2007). According to Prospect Theory, individuals make decisions using a process involving editing and evaluation. First, people set a reference point and rank outcomes according to this reference point. Secondly, the individual determines a (utility) value based on the potential outcome and its perceived probability.

5.4.8 Furthermore, the concept of ‘Loss Aversion’, developed by Kahneman and Tversky, has evolved from research that has demonstrated that individuals feel more pain from a particular loss than they do from the equivalent financial gain. Some studies suggest this Perceived Value of loss is twice the Perceived Value of a gain. So the Real Value Added of advice to invest R100 may be R49, but due to the investor’s perception that the money might be lost, he may conclude that the Perceived Value Added of that advice is negative since there is a chance of losing the R100.

5.4.9 At different points in time an individual could place different Perceived Values on a financial consequence. For example, the compulsory retirement savings could be Real Value positive for individuals, but if they perceive their consumption needs as more important (e.g. because of retrenchment concerns) then the savings would have negative Perceived Value. This would then be evaluated as follows:

- Real Value: Positive
- Economic Value: Positive
- Community Value: Positive
- Perceived Value: Negative

5.5 Statistical Value

5.5.1 The likely outcome, or the distribution of outcomes, of a decision could also be considered. Certain decisions can increase or decrease the probability of attaining the desired outcome by varying percentages. For example, using a particular asset allocation might change the probability of meeting an investment objective from 50% to 75%. This is a statistical improvement in the probability of achieving a desired objective, but an individual cannot consume probabilities. The individual will either achieve the result (and be happy), or not achieve the desired result (and be destitute). The fact that success may be 25% more likely does not change the fact that, ex post, one deterministic outcome (success or failure) will be realised.

5.5.2 The key is that statistical calculations work well when considering large numbers of individuals or pieces of advice, but for one specific individual the outcome will always be one of the extremes.

5.5.3 Thus, in the context of individual advice, Statistical Value is not particularly useful as a measure.

This section has defined five methods of determining value in the context of the value added by advice. Each method has its advantages, disadvantages and appropriate usage. The next section reviews the costs incurred by advisers in providing advice, followed by a section showing the cost of advice faced by consumers.
6 Cost of Advice Provision

This section outlines some of the considerations of an independent financial advice practice from the perspective of business and profit generation. It is not intended to be an exhaustive treatment of the economics of running a practice, but meant to highlight the main issues.

6.1 How Does a Practice Work?

6.1.1 A financial advisory practice can be structured as one of the following legal entities:
- Sole Proprietor
- Partnership
- Close Corporation with one member
- Close Corporation with multiple members
- Proprietary Unlisted Company (Private Company)
- Public Company
- Trust

6.1.2 In today's FAIS environment this is an important consideration in terms of who is ultimately liable for poor advice: the individual or the legal entity?

6.1.3 In terms of its relationship with product providers, a practice can be:
- independent and authorised to market the products of many providers,
- 'multi-tied' (contracted) to a limited number of providers, or
- 'tied' to one provider.

This is relevant in terms of the number of products which the adviser must keep track of, and potentially defines the independence and breadth of the adviser’s advice.

6.1.4 Debate has been stimulated by the National Treasury in its Discussion Paper on Contractual Savings (2006) around which category of financial adviser shall be permitted to earn fees (paid by the consumer) and which shall be permitted to earn commission (paid by the product provider). This debate is well developed in the UK, Australia and the USA. This paper does not comment on this other than to say that the type of legal entity and its relationship with product providers can have a material impact on an adviser’s ability to provide 'best' or even 'appropriate' advice given the complexity and multitude of product choices available.

6.2 What Does an Adviser Do?

6.2.1 The activities of a financial advisory practice include:
- Prospecting for clients
- Preparation of documentation for a client visit
- Client visit
- Preparation of financial needs analysis
- Preparation of product quotations
- Presentation of needs analysis and solutions to client
- Periodic review of client’s financial circumstances and continued appropriateness of client’s product holdings
- Continued education and training of representatives
- Compliance Management
• Compliance Audit (could be external)
• Bookkeeping: expense payments, accounting entries
• Travel to clients
• Office maintenance
• Documentation, record keeping and filing
• Commission/Fee reconciliation
• General administration
• Auditing (external auditor)
• System and telecommunications maintenance
• Product provider liaison
• Product research
• Due Diligence research of product providers
• Economic and environmental research

6.2.2 FAIS makes a distinction between advice and intermediary services. In the context of what the adviser does it is important not to underplay the administrative intermediary service. Financial products are complex, with numerous rules and conditions. Furthermore, the processes and procedures that need to be followed by financial institutions to protect consumers and protect the institution can also be complex to the uninitiated. Individuals will never deal with these procedures as frequently as advisers fulfilling an intermediary service would do and thus will not be familiar with the processes. Individuals can experience significant time saving (and hence value) through the intermediary service provided by an adviser.

6.2.3 In proprietary research conducted by Masthead\(^4\) in 2007\(^5\), the following estimates were derived:

<table>
<thead>
<tr>
<th>Table 1 - Key Adviser Productivity Metrics</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Averages</strong></td>
</tr>
<tr>
<td>Number of hours worked by principal and representatives</td>
</tr>
<tr>
<td>Percentage of time worked on income generating activities</td>
</tr>
<tr>
<td>Adviser: support staff ratio</td>
</tr>
<tr>
<td>Number of client appointments</td>
</tr>
<tr>
<td>Duration of client appointment</td>
</tr>
<tr>
<td>% of appointments away from office</td>
</tr>
<tr>
<td>Travel time to each appointment</td>
</tr>
<tr>
<td>% appointments resulting in income</td>
</tr>
<tr>
<td>Income earned from successful appointment</td>
</tr>
</tbody>
</table>

---

\(^4\) Masthead Distribution Services is the largest broker network in South Africa. It has approximately 2,800 members.

\(^5\) Sample size 130 independent financial advisers.
6.3 How Much Does a Practice Earn?

6.3.1 The Masthead survey (2007) showed average annual incomes as follows:

Table 2 - Average Practice Incomes

<table>
<thead>
<tr>
<th></th>
<th>Single Adviser Practice</th>
<th>2-3 Adviser Practice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Practice Income</td>
<td>R713,000</td>
<td>R1,071,500 (a)</td>
</tr>
</tbody>
</table>

New Business | 58%  
Renewal income | 19%  
Trail Commission | 11%  
Fees | 2%  
Other (short-term) | 10%

Source of Income
(Masthead 2007)

Figure 12 - Source of Adviser Income

6.4 Practice Costs

6.4.1 The provision of financial advice is a service business, requiring fairly little in terms of capital investment, and dominated by staff salaries in terms of costs. The following salary brackets are illustrated based on the authors’ anecdotal evidence:

Table 3 - Approximate Salaries

<table>
<thead>
<tr>
<th>Staff Level</th>
<th>Monthly Salary</th>
<th>Effective Hourly Cost</th>
<th>Market Hourly Charge Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Senior Financial Adviser</td>
<td>R50,000</td>
<td>R300</td>
<td>R1 000</td>
</tr>
<tr>
<td>Financial Adviser</td>
<td>R30,000</td>
<td>R180</td>
<td>R700</td>
</tr>
<tr>
<td>Legal Adviser</td>
<td>R25,000</td>
<td>R150</td>
<td>R500</td>
</tr>
<tr>
<td>Paraplanner</td>
<td>R20,000</td>
<td>R120</td>
<td>R350</td>
</tr>
<tr>
<td>Senior Administration Staff</td>
<td>R10,000-R15,000</td>
<td>R80</td>
<td>R200</td>
</tr>
<tr>
<td>Junior Administration Staff</td>
<td>R2,500 - R10,000</td>
<td>R40</td>
<td>R100</td>
</tr>
</tbody>
</table>

Note that according to Masthead, the ‘2-3 Adviser Practice’ typically has one senior adviser generating similar income of the ‘Single Adviser Practice’ plus 1-2 junior advisers doing short-term insurance and/or medical scheme business in the practice bringing in a much lower income (in the region of R300,000 p.a.).

7 A paraplanner is an office bound adviser assistant who would prepare a full financial needs analysis based on the client's information. The adviser then acts as the communicator of this plan.

8 Masthead (2007) estimated an average support staff salary of R5,551, with vast differences between Cape Town (R3,295), Johannesburg (R8,885) and Pretoria (R5,098).
6.4.2 The following average costs were derived from the Masthead survey (2007):

<table>
<thead>
<tr>
<th>Table 4 - Average Costs (Masthead)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Average Annual Cost</strong></td>
</tr>
<tr>
<td>Salary: Key Individual/Adviser</td>
</tr>
<tr>
<td>Salary: Support</td>
</tr>
<tr>
<td>Telephone</td>
</tr>
<tr>
<td>Premises/Rent</td>
</tr>
<tr>
<td>Vehicle Payments</td>
</tr>
<tr>
<td>Vehicle Maintenance</td>
</tr>
<tr>
<td>Entertainment</td>
</tr>
<tr>
<td>Premises Maintenance</td>
</tr>
<tr>
<td>Other</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

6.4.3 Netting these average costs off against the average practice revenue for a Single Adviser Practice leaves an additional R41,000 which the adviser will be able to draw a bonus dividend or can retain with the business to fund later income. The typical total earnings for an adviser is thus approximately R320,000 per annum or R27,000 per annum based on Masthead data.

6.4.4 As with all professions there are many individuals who earn well below the average and a select number of successful individuals who earn significantly more than the average.

6.5 Summary

6.5.1 The above evidence suggests that the financial advice industry is not excessively well remunerated. The salaries and hourly costs suggest a market-related income given the level of qualifications now required by advisers under the FAIS Act. In particular, it should be noted that advisers are exposed to considerable risk of being accused of giving inadequate or inappropriate advice; the penalties for which are significant in the FAIS Act.

Having illustrated the costs of operating a financial advisory practice, the next section illustrates the cost to the consumer of typical charging structures.
7 **Cost of Advice to the Consumer**

This section covers the cost to the consumer of advice where charges are built into the financial products purchased.

7.1 **Measurement Methods**

7.1.1 Both Reduction in Yield (RIY) and Reduction in Maturity Value (RiMV) measures are used to demonstrate the cost of advice in the tables below. All projected values presented are in real terms. These measures quantify the opportunity cost to the consumer of paying for advice and are not equivalent to the actual commission paid to the adviser. The methodology used to develop the model for calculating these measures is detailed in the Appendix. The RIY and RiMV (in percentage terms) are sensitive to changes in the investment term but not premium size. For purposes of illustration, a R500 per month recurring premium and a R10,000 single premium investment are used.

7.1.2 Note that the legal distinction between commission and advice fees is not important for the purposes of this analysis. The terms may be assumed to have the same meaning in the body of this paper.

7.2 **Recurring Premium Products**

7.2.1 Commission payable by long-term insurers on retirement annuity (RA) and endowment policies are regulated, and the current maximum allowable commission structure is used to derive the cost table below. (Commission regulations are presently being revised to reduce the quantum of commission payable upfront and the resultant RIY due to commission is expected to reduce. The proposed regulations are in draft stages at the time of writing this paper and hence the current commission structure is used to demonstrate the cost of advice). Since unit trust (collective investment scheme) commissions are not regulated, a typical 3.42% (3% plus VAT) per premium advice fee charge with no trail fee is used for the illustration of costs. Figures are VAT inclusive.

7.2.2 Note that life insurance companies in South Africa have voluntarily chosen to cap the commission term for endowment business at 15 years, hence no numbers are presented in the 20 and 25 year columns in Table 5.
Table 5 - Cost of Commission, R500 p.m. recurring premium

<table>
<thead>
<tr>
<th>Current RA</th>
<th>5</th>
<th>10</th>
<th>15</th>
<th>20</th>
<th>25</th>
</tr>
</thead>
<tbody>
<tr>
<td>3% Upfront</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross Maturity Value (Rands)</td>
<td>31,149</td>
<td>65,903</td>
<td>106,921</td>
<td>157,426</td>
<td>221,466</td>
</tr>
<tr>
<td>RIMV due to Commission (Rands)</td>
<td>-1,558</td>
<td>-4,152</td>
<td>-8,298</td>
<td>-14,739</td>
<td>-24,545</td>
</tr>
<tr>
<td>Net Maturity Value (Rands)</td>
<td>29,590</td>
<td>61,751</td>
<td>98,623</td>
<td>142,686</td>
<td>196,921</td>
</tr>
<tr>
<td>RIMV due to Commission %</td>
<td>5.0%</td>
<td>6.3%</td>
<td>7.8%</td>
<td>9.4%</td>
<td>11.1%</td>
</tr>
<tr>
<td>RIY DUE TO COMMISSION</td>
<td>2.1%</td>
<td>1.2%</td>
<td>1.0%</td>
<td>0.8%</td>
<td>0.7%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Current Pure Endowment</th>
<th>5</th>
<th>10</th>
<th>15</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.25% Upfront</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross Maturity Value (Rands)</td>
<td>31,149</td>
<td>65,903</td>
<td>106,921</td>
</tr>
<tr>
<td>RIMV due to Commission (Rands)</td>
<td>-1,688</td>
<td>-4,498</td>
<td>-8,989</td>
</tr>
<tr>
<td>Net Maturity Value (Rands)</td>
<td>29,461</td>
<td>61,405</td>
<td>97,932</td>
</tr>
<tr>
<td>RIMV due to Commission %</td>
<td>5.4%</td>
<td>6.8%</td>
<td>8.4%</td>
</tr>
<tr>
<td>RIY DUE TO COMMISSION</td>
<td>2.2%</td>
<td>1.3%</td>
<td>1.0%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>UT</th>
<th>5</th>
<th>10</th>
<th>15</th>
<th>20</th>
<th>25</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.42% per premium (incl. VAT), no trail commission</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross Maturity Value (Rands)</td>
<td>31,153</td>
<td>65,922</td>
<td>106,970</td>
<td>157,527</td>
<td>221,654</td>
</tr>
<tr>
<td>RIMV due to Commission (Rands)</td>
<td>-1,066</td>
<td>-2,254</td>
<td>-3,658</td>
<td>-5,387</td>
<td>-7,580</td>
</tr>
<tr>
<td>Net Maturity Value (Rands)</td>
<td>30,087</td>
<td>63,668</td>
<td>103,312</td>
<td>152,140</td>
<td>214,073</td>
</tr>
<tr>
<td>RIMV due to Commission %</td>
<td>3.4%</td>
<td>3.4%</td>
<td>3.4%</td>
<td>3.4%</td>
<td>3.4%</td>
</tr>
<tr>
<td>RIY DUE TO COMMISSION</td>
<td>1.4%</td>
<td>0.7%</td>
<td>0.4%</td>
<td>0.3%</td>
<td>0.2%</td>
</tr>
</tbody>
</table>

7.3 Single Premium Products

7.3.1 As with recurring premium products, commission and/or advice fees on single premium products vary depending on the legal vehicle. For illustration purposes, the cost is calculated based on the typical commission paid on endowment products: 2.85% of premium and 0.57% p.a. trail fee. On unit trust products, trail fees of up to 1.14% p.a. are common in the industry. Figures are VAT inclusive.

Table 6 - Cost of Commission, R10,000 single premium investment

<table>
<thead>
<tr>
<th>Investment Term</th>
<th>5</th>
<th>10</th>
<th>15</th>
<th>20</th>
<th>25</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.85% of premium, 0.57% trail commission</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross Maturity Value (Rands)</td>
<td>13,325</td>
<td>17,757</td>
<td>23,662</td>
<td>31,530</td>
<td>42,016</td>
</tr>
<tr>
<td>RIMV due to Commission (Rands)</td>
<td>-744</td>
<td>-1,462</td>
<td>-2,559</td>
<td>-4,200</td>
<td>-6,620</td>
</tr>
<tr>
<td>Net Maturity Value (Rands)</td>
<td>12,582</td>
<td>16,294</td>
<td>21,103</td>
<td>27,331</td>
<td>35,396</td>
</tr>
<tr>
<td>RIMV due to Commission %</td>
<td>5.6%</td>
<td>8.2%</td>
<td>10.8%</td>
<td>13.3%</td>
<td>15.8%</td>
</tr>
<tr>
<td>RIY DUE TO COMMISSION</td>
<td>1.3%</td>
<td>1.0%</td>
<td>0.8%</td>
<td>0.8%</td>
<td>0.8%</td>
</tr>
</tbody>
</table>

7.4 Summary

7.4.1 Costs vary by product type, savings frequency (recurring vs. single premium) and by term. A rough rule of thumb, as a takeout from this section, is that advice costs in the region of 1% p.a. In later sections the value of advice in worked examples is compared to the cost of advice.

In the next section the focus moves away from the cost of advice to the topic of access to financial services. This topic is of particular importance for efforts aimed at improving the financial well-being of lower income consumers.
8 Access to Financial Services

This section deals with conflicting market actions in the context of trying to improve consumers' access to financial services.

8.1 The Current Focus of Access Initiatives

8.1.1 According to Finscope (2006) research, 49% of South African adults are unbanked (individuals who have never opened a bank account). The same research shows that many consumers rely on expensive informal credit to fund school fees and funeral costs.

8.1.2 If these individuals are integrated into the formal financial system, their financial needs can be more appropriately satisfied. Integration into the formal financial system for individuals who currently enjoy no access to financial services will shift individuals into the positive value zone (Quadrants 1 and 2) in the Advice-Value Framework. Unfortunately, there are many barriers that prevent this integration. Examples include location (the considerable distance of rural communities from product provider branches and bank ATMs) and the transactional cost associated with products, resulting in poor value for money on small amounts invested.

8.1.3 The Financial Sector Charter (FSC) focuses on increasing access to financial products for South Africa's 17.5 million low-income earners with a monthly salary of less than R2,600 (LOA, 2005). The FSC's defined targets can only be achieved by:

- the development of appropriate products (that meet identified needs and are affordable and simple),
- ensuring transactional access, and
- increasing individual and community awareness of financial services offerings and its value.

8.1.4 The focus of efforts aimed at increasing access for low-income earners has largely concentrated on affordability and cost reduction. To this end, the market has seen the successful introduction of Mzansi bank accounts and Zimele approved funeral products (Finscope, 2006).

8.1.5 The regulatory environment presents an interesting challenge to financial service provision in South Africa. Both consumer protection and access to financial services are policy goals of government.

8.1.6 With the problems of low savings, decision-making and market failures, government has proposed mandatory participation in retirement savings. Compulsory retirement savings would improve the security of retirement income benefits from the current reality and would move individuals firmly into Quadrant 2 - the no-advice/positive-value quadrant in the Advice-Value Framework.

8.1.7 National Treasury's (2006) discussion paper on contractual savings in the life insurance industry initiated a process to change commission regulations in order to improve customer
value, among other things. Against a backdrop of high costs and poor surrender values, these new regulations will reduce the amount of commission paid to financial advisers and change the incidence of commission with a greater proportion spread over time as opposed to being paid upfront.

8.1.8 At the same time, FAIS legislation imposes strict requirements on the operations of financial advisers. These requirements, whilst aimed at protecting the consumer, make it more complex and therefore more costly for existing advisers to operate in the current environment as well as for new advisers to enter the market. The ultimate result of a reduction in commission, coupled with an increase in the costs incurred in providing financial advice, will be a reduction in the supply/availability of advice. As existing financial advisory channels become increasingly more expensive to operate, the reality is that independent financial advisers will be forced to stop dealing in low-premium markets.

8.1.9 Similar problems have manifested internationally. In the UK, the Financial Services Authority (FSA) is concerned that the increasing compliance burden on advisers has led to fewer advisers servicing middle-income consumers who need to save and have the financial means to do so. The FSA is now actively considering more relaxed compliance regimes for certain sets of products in an attempt to reduce the cost to advisers of providing advice. This will increase the number of advisers servicing the middle-income market in the UK, thus improving access to financial advice for consumers. The ‘Primary Advice’ model proposed is a less stringent compliance regime for a limited set of products (FSA, June 2007).

8.2 Possible Solutions

8.2.1 As a response to the increasing regulatory cost of advice-based sales, the South African market has seen the rise of financial adviser networks that share office costs, call-centre supported agency forces and tiered agency forces (Genesis Analytics, 2006). These new models, adapted to operating in a more expensive environment, are part of the solution.

8.2.2 Drawing on lessons from the UK market, other potential solutions could involve reducing the cost burden to financial advisers of operating in lower income markets. This could be achieved by segmenting the market for advisers depending on the depth and breadth of services offered; with regulatory requirements increasing as the level of services offered increases (more so than they currently do). Another alternative is to incentivise advisers to operate in lower income markets. The current emphasis has been to increase the cost of providing advice coupled with a reduction in the remuneration to advisers. The authors believe that the value of advice (as opposed to merely the cost) has not been adequately considered in this process. This is a major shortcoming of current debate. In terms of the Advice-Value Framework and the notion of Net Real Value Added, the objective should be to enhance access to advice that is positive in value, even if this means increasing the price of that advice. The trade-off is the quantum of Real Value Added vs. the cost.
8.2.3 Underlying the approach to access, and fundamental to the optimal functioning of the system, are efforts aimed at improving the financial literacy of South Africans. Finscope Survey (2006) showed that 60% of respondents did not understand the meaning of the financial term ‘interest rates’. This is evidence of the daunting information asymmetries that exist in the country’s financial landscape. Advisers play a critical role in bridging the gap between the financial sophistication of product providers on the one end and the financially illiterate on the other. To this end, the role that advisers play is associated with a high, positive Community Value. However, for both product providers and advisers to try to improve the access situation, it is imperative that consumers themselves have some level of financial understanding so as to make appropriate decisions.

8.2.4 In conclusion, it is critical to recognise the conflict in the regulatory aims of consumer protection and increasing access to financial products. Reducing the cost of products by lowering commission minimises the income to financial advisers. This reduction in income, coupled with increasing compliance costs, will directly result in advisers exiting low-premium markets. While the authors believe this is an unintended consequence of some of the recent regulatory changes in South Africa, the end result is a lower Community Value due to the reduction in access to financial advice and financial products. This is a mistake that several other countries (e.g. the UK and Australia) have already made and are now attempting to correct through further changes to their regulatory regime.

The following section applies the Advice-Value Framework to selected topical examples.
9 Discussion of Selected Examples of Advice

This section illustrates the issues outlined in the Advice-Value Framework with specific examples of financial advice and the advisory process. The examples selected are not intended to be comprehensive, but are intended to illustrate the value of good advice compared to poor advice in some common situations or choices faced by consumers.

9.1 Single vs. Full Needs Analysis

9.1.1 The issue under consideration here is whether it is appropriate to perform a single need advice process. This topic has arisen within the FAIS environment and is of concern to the Financial Services Board (FSB).

9.1.2 In the continuum of advice that is offered, or accepted, by the consumer, a full needs analysis compared to single need advice can be shown graphically.

![Full Needs Analysis vs. Single Need Advice](image)

9.1.3 A full needs analysis would need to cover the following:

<table>
<thead>
<tr>
<th>Product Orientated</th>
<th>Process Orientated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retirement Provision, Education funding</td>
<td>Budgeting</td>
</tr>
<tr>
<td>Life/Disability Insurance</td>
<td>Income Management</td>
</tr>
<tr>
<td>Health Care Provision/Insurance</td>
<td>Expense Management</td>
</tr>
<tr>
<td>Short Term Insurance</td>
<td>Financial Literacy</td>
</tr>
<tr>
<td>Transactional Banking, Bank Savings</td>
<td>Wills, Trusts and Executorships</td>
</tr>
<tr>
<td>Debt Management</td>
<td>Tax</td>
</tr>
</tbody>
</table>

Figure 14 - Full Needs Analysis vs. Single Need Advice
9.1.4 Some of the needs are such that the goal can be articulated, the numbers computed to determine the quantum of the need and a product put in place. However, there are many needs that relate purely to financial literacy and money management. Simple monthly household budgeting would make a tremendous difference to certain individuals. Benefits can arise from cash flow management or from more prudent lifestyle choices.

9.1.5 A full needs analysis would require an adviser to assist his client to prioritise her needs. This prioritisation would generally require one or more of the following criteria:

- net effect on the client’s future net worth, i.e. Real Value Added,
- client’s ability to maintain the commitment to a product solution,
- psychological impact of the needs that are addressed, and
- psychological impact of the needs that are not addressed.

9.1.6 If only single need advice is given, then this ranking of financial priorities is not undertaken. This can be appropriate in certain circumstances, including:

- the purchase of a house,
- entry into or exit from a pension fund, or
- the receipt and investment of a lump sum.

9.1.7 In particular, if the client has a single need requiring attention, then she might not require an adviser to go into all other aspects of her financial affairs. This is the consumer’s choice, and a continued insistence to review other matters can be viewed by the consumer as an unwelcome attempt by the adviser to pry into the other facets of her financial life.

9.1.8 However, there are circumstances where a single need process is inappropriate. In the terminology of the Value of Advice, a single need (or less than full needs) analysis could have negative value. Assume the single need analysis solution gives a positive Real Value. The consumer has a positive Perceived Value of this solution, but the lack of prioritisation of needs means that another more significant need is not met. The Real Value Added of not meeting that need is negative, i.e. the inaction has negative Real Value, but advice in this area would have created Real Value. The Net Real Value Added to the consumer could then be negative where financial resources are directed to an inappropriate area resulting in a bigger negative Real Value Added from the unmet need than the positive Real Value Added of the met need.

9.1.9 It is difficult to suggest how to solve this situation. If the consumer has a high degree of financial literacy, he can do this priority setting for himself. However, it can be very difficult to determine these relative values and the intervention of an adviser would often result in an improved outcome. There is also evidence that suggests that even knowledgeable practitioners do not undertake this priority setting appropriately for their own finances (Timura, 2006). Thus the ideal would be to:

- improve financial literacy of consumers,
- provide greater access to financial advisers, and
- encourage full needs analyses.

9.1.10 The level of skill, expertise and experience required to do a full needs analysis is considerable. Even a Certified Financial Planner (CFP) will need to be familiar with the latest developments in legislation and with products across a broad spectrum of product providers. A larger practice may be able to sustain a research department to support its
advisers, but a one-man advisory business cannot hope to keep up. So it is likely that many practices will focus on specific product lines and prospect for single-need clients only.

9.1.11 Single need financial service provision is prevalent in South Africa. The authors contend that it is sometimes appropriate and often the wish of the consumer. The danger is that the prioritisation of financial services is then never understood by the consumer. In this case one need will be successfully satisfied and plotted in Quadrant 1 on the Advice-Value Framework but the holistic outcome experienced by this consumer is likely to be positioned in Quadrant 3.

9.2 Risk Profilers

9.2.1 The Real Value methodology can be used to illustrate the danger of risk profile based investment fund selection.

9.2.2 With the advent of FAIS, the requirement to perform a documented determination of the appropriate investment risk/return tolerance for an investor has become mandatory. The common method seems to be to present the client with a set of questions designed to address many of criteria required to make the decision. These ‘questionnaire style’ methods have been criticised by Boulle (2006) and MacDonald (2007).

9.2.3 There are two general types of information that need to be taken into account when determining the appropriate asset allocation for an individual, namely personality related issues and financial goal issues.

9.2.4 Behavioural finance has emerged as a field of study that attempts to understand people's relationships with money and their ability to tolerate investment risk to achieve their financial goals. Information is elicited to try to understand which future alternatives the individual would prefer, for example ‘would you prefer a chance of earning a 20% return, but possibly losing 20%, or rather the chance of earning only 10% with the risk of a maximum of 10% loss’. Questions of this nature are problematic. The answer given can depend on the way in which the question is framed, the specific events the individual has in mind, or the current talking points of the day (Taylor, 2000).

9.2.5 If a consumer can define his financial goals, then it is possible to design his likely future income and outgo. This model will then generate the required investment return to meet his goals. This asset/liability modelling is familiar to actuaries in the context of pension funds and insurance companies. However, there are a number of differences, including the fact that the law of large numbers cannot be relied upon. An expected mortality rate of 2/1000 for a life company means two claims out of every thousand lives every year. For an individual it means life or death; there is no average.

9.2.6 Risk profile questionnaires inadequately try to combine the personality and objective information. The result can be significant for a client. Take for example an investor who is cautious by nature. Their risk profile questionnaire reflects this caution and suggests a conservative risk profile. The appropriate investment fund is then identified as a fund with an ‘inflation plus 2%’ mandate. A more objective evaluation of the individual’s circumstances identifies that the investment in question has a 20-year time frame and is thus best matched with a portfolio with an ‘inflation plus 5%’ mandate. The consumer can expect to be 44% worse off in the more cautious portfolio.
9.2.7 The adviser who constructs a correct investment mandate for this individual, not based on the poorly constructed risk profiler, will thus create positive Real Value. For example, if this decision was applied to a R100,000 investment, the Real Value Added by the adviser is R117,000, i.e. bigger than the original investment. Assuming a 1% per annum adviser fee for this advice, the Net Real Value Added is R71,000.

9.2.8 Risk profile questionnaires are appropriate to collect information and to determine some facets of investor personalities. However, they need to be very carefully constructed and should not be the sole basis for the selection of investment funds.

9.3 Illustrating the Power of Compound Interest

(The iconic Albert Einstein is credited with the alongside quote and a few other colourful variations as well. However, a simple Google search turns up thousands of conflicting views. It seems as if the origins of the quote are actually not verifiable. Lest the myth is perpetuated, Albert Einstein will be left out of this equation for now, and the quote will be attributed to a genius nonetheless.)

The most powerful force in the universe is compound interest

Time Value of Money

9.3.1 In its simplest and most powerful form, the Real Value of financial advice is in getting compound interest to work for people.

9.3.2 Time value of money means that a sum of money today is worth more than the same sum of money at a future point in time. The reason is inflation and the opportunity cost of money. Investors receive interest as compensation for the use of capital, for the risks associated with inflation and the use of the underlying asset.

9.3.3 Compound interest is interest earned on interest and on the underlying principal, with the value of compounding increasing significantly over time. Consider for example the young first-jobber, aged 25, who (resisting the urge to spend) begins to save R250 per month, increasing her savings annually with inflation. As indicated in the graph below, the Real Value Added of the investment (real fund value less cumulative contributions) increases exponentially over time as a result of compound growth. The wealth of the young saver is increased by R11,000 after the first 10 years. At the end of 20 years, real wealth is increased by over R50,000, or almost 5 times as much as after the first 10 years.

Calculation is consistent with a gross return of 11.2% p.a. as per the Moderately Aggressive Portfolio return detailed in the Appendix.

9\footnote{Calculation is consistent with a gross return of 11.2\% p.a. as per the Moderately Aggressive Portfolio return detailed in the Appendix.}
9.3.4 Now, assume that on the advice of an adviser, the investor contributes R250 p.m. increasing at inflation, to a retirement annuity fund. The table below indicates the total increase in real worth at retirement at age 60 (ignoring the value of the tax deferral through the retirement savings vehicle) under two different scenarios. The first scenario projects a final Real Value Added of R98,000, assuming the RA vehicle has an associated total charge of 2.5% p.a. Of this 2.5% p.a., 0.7% p.a. is attributable to the cost of commission payable to the adviser. The second scenario illustrates a Real Value Added of R128,000, assuming that there is no cost of advice built into the investment (i.e. the total annual charge reduces to 1.8%).

Table 8 – Projected Values at Retirement

<table>
<thead>
<tr>
<th>Scenario 1: Including advice</th>
<th>Scenario 2: Excluding advice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Projected Fund Value (Real Terms)</td>
<td>Contributions (Real Terms)</td>
</tr>
<tr>
<td>R 201,000</td>
<td>R 103,000</td>
</tr>
<tr>
<td>R 231,000</td>
<td>R 103,000</td>
</tr>
</tbody>
</table>

9.3.5 To summarise then, the investor forgoes R30,000 in real terms (R128,000 - R98,000), in return for a real increase in value of R98,000, with the value of the advice far outweighing the cost.

9.3.6 At this point it is important to compare this calculation and its meaning to the popular arguments about the cost of advice (for instance, in Rusconi, 2004). While costs are clearly very important, merely comparing values with and without costs and highlighting the reduction in maturity value as a result of costs, can be misleading as it does not take account of the value of the advice.

9.3.7 The arguments set out earlier in this paper of the savings crisis in South Africa, and the strong consumer preference for instant gratification, lead to the conclusion that without being persuaded by an adviser to save for retirement, the vast majority of South Africans
would consume the money instead. This means that the final values after costs should also be compared to a zero final maturity value (or a substantially lower one than the values in the scenarios above on the assumption that the consumer eventually does start saving but obviously then only for a shorter period). Such a comparison clearly demonstrates the value of the advice.

9.3.8 Action or regulation aimed at reducing the cost is certainly beneficial, but not if it also reduces the value.

Start Early – Scenario 1

9.3.9 To demonstrate the power of starting early, consider the following example: two investors, aged 35 and 45, begin to save for retirement at the same time. They each invest R500 p.m. (increasing each year by inflation) at a net-of-charges annualized return of 8.7%\(^{10}\).

9.3.10 The following tables illustrate the projected fund values and contributions, in both nominal and real terms, for both investors (values are rounded to the nearest R1,000).

### Table 9 - Projected Values (Rands) for 35-year-old

<table>
<thead>
<tr>
<th>End of Year</th>
<th>Age</th>
<th>Nominal Terms</th>
<th>Real Terms</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Fund Value</td>
<td>Contributions</td>
</tr>
<tr>
<td>5</td>
<td>40</td>
<td>41,000</td>
<td>33,000</td>
</tr>
<tr>
<td>10</td>
<td>45</td>
<td>114,000</td>
<td>75,000</td>
</tr>
<tr>
<td>15</td>
<td>50</td>
<td>240,000</td>
<td>129,000</td>
</tr>
<tr>
<td>20</td>
<td>55</td>
<td>450,000</td>
<td>198,000</td>
</tr>
<tr>
<td>25</td>
<td>60</td>
<td>791,000</td>
<td>286,000</td>
</tr>
<tr>
<td>30</td>
<td>65</td>
<td>1,339,000</td>
<td>399,000</td>
</tr>
</tbody>
</table>

### Table 10 - Projected values (Rands) for 45-year old

<table>
<thead>
<tr>
<th>End of Year</th>
<th>Age</th>
<th>Nominal Terms</th>
<th>Real Terms</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Fund Value</td>
<td>Contributions</td>
</tr>
<tr>
<td>5</td>
<td>50</td>
<td>41,000</td>
<td>33,000</td>
</tr>
<tr>
<td>10</td>
<td>55</td>
<td>114,000</td>
<td>75,000</td>
</tr>
<tr>
<td>15</td>
<td>60</td>
<td>240,000</td>
<td>129,000</td>
</tr>
<tr>
<td>20</td>
<td>65</td>
<td>450,000</td>
<td>198,000</td>
</tr>
</tbody>
</table>

9.3.11 Assuming that they both decide to retire at age 60, the Real Value Added of the investment to the 35-year-old amounts to R88,000 (R235,000 fund value - R147,000 in contributions) as compared to a Real Value Added of R28,000 to the 45-year-old (R116,000 fund value - R88,000 in contributions). By saving for less than double the term as the 45-year-old (25 years vs. 15 years), the 35-year-old increased his Real Value by over 3 times as much. Hence, the adviser who convinces the person to start saving at age 35 rather than at age 45 has created Real Added Value of R60,000 from his advice.

9.3.12 The nominal retirement value at age 60 for the 35-year-old is R791,000 (Table 9). To illustrate the importance of starting to save early, this final fund value is broken down into the percentage attributable to contributions and growth within the first 10 years and thereafter. In Figure 16 below it can be seen that 64% of the final value is generated from growth (or compound interest) with the balance stemming from contributions. The first 10

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\(^{10}\)Gross growth rates are consistent with a Moderately Aggressive Portfolio, see Appendix for derivation.
years’ premiums contribute 9% to the maturity value. Of great significance, however, is the fact that the first 10 years of savings (premiums plus growth) contribute to 50% of the maturity value. The benefit of compound interest is an important reason why one should not rely on the last 15 years before retirement for adequate retirement planning.

![Figure 16 - Components of Fund Value](image)

**Figure 16 - Components of Fund Value**

9.3.13 In order for the 45-year-old to be in the same purchasing power position at retirement as the 35-year-old, his starting contribution would need to double from R500 p.m. to just over R1000 p.m. This means that over the remaining 15-year period to retirement, he would have made contributions of R178,000 in present terms. The 35-year-old, however, contributes only R147,000 (Table 9) to maintain the same purchasing power.

**Start Early – Scenario 2**

9.3.14 Consider two people, Mr X and Ms Y, each saving R500 pm. with contributions increasing with inflation. Mr X starts saving at age 35 with the intention to retire at age 65. In contrast, Ms Y, aged 25, enters into a 10-year commitment to save. At age 35, she opts for preservation and, as a result, her accumulated wealth remains invested.

9.3.15 Figure 17 below shows that it takes Mr X 33 years to eventually catch up to Ms Y After 33 years the fund value at the catch-up point, in real terms, is R217,000. Mr X invests contributions to the value of R117,000 to achieve this, whereas Ms Y has only contributed R59,000. The first 10 years’ worth of contributions made by Ms Y is more valuable than the later contributions made by Mr X because of the impact of compound interest on the early savings. The Real Value of the investment added to Mr X is R100,000 (R217,000 fund value - R117,000 in contributions) and the value added to Ms Y is R158,000 (R217,0000 fund value - R59,000 in contributions). In this example, simply starting early and preserving her maturity value has made Ms Y R58,000 richer.

*The earlier you start saving, the cheaper it is to fund retirement*
The above examples show that simple advice can add significant positive Real Value to an investor. Essentially, sound financial planning encompasses that an individual start early with a reasonable plan to reach their goals. The point is really simple: save, save enough, start early, and let compounding do the rest.

### 9.4 Asset Allocation Decisions

9.4.1 In the process of portfolio construction, asset allocation refers to the choice of asset classes for investment and the corresponding weights assigned to each class, in order to meet the specific needs of investors. Asset allocation decisions are important for a number of reasons, including their importance to portfolio return. Studies by Brinson (1986, 1991) and Ibbotson (2000) (cited in Van Schalkwyk & Hattingh, 2005) found that over 90% of a portfolio’s return over time can be attributed to its asset allocation policy.

9.4.2 A low level of financial knowledge makes it difficult for individuals to make efficient asset allocation decisions. Van Schalkwyk & Hattingh also cite Huber & Kaiser (2003) who highlight that financial advisers make asset allocation recommendations based on factors such as the individual’s stage of life, risk tolerance, investment goals and liquidity needs. An important part of the value of financial advice lies in the adviser bridging the knowledge gap to help select an investment suitable to the investor’s needs.

9.4.3 Often individuals make investment choices or find themselves in situations that have significant consequences for their financial well-being without being aware of it. Such examples include: membership of an occupational pension fund, the purchase of a house, or even a bank deposit.

9.4.4 Saving in cash assets is appropriate for a short-term horizon or for use as emergency funds where returns are stable and liquidity is high. The Finscope Survey (2006) showed that almost 30% of respondents were using bank accounts to save. This figure increased to well over 50% for higher LSM groups. It is not clear whether such savings are intended as short-
term savings or for use as emergency funds. Of significance, however, is the fact that the proportion of people saving via cash mechanisms far outweighs the number of people saving via long-term vehicles that allow the necessary exposure to equity investments and other asset classes.

9.4.5 The examples in this section demonstrate that investors are prone to making poor long-term asset allocation decisions due to an insufficient appreciation of the investment risk-reward trade-off. Advisers can play a valuable role in correcting the situation. Before exploring the examples, however, it is useful to briefly consider the historical returns on asset classes and the volatility of equity returns.

Historical Real Returns and Volatility

9.4.6 For many individuals future expenditure is expected to increase by some measure of inflation, such as consumer price inflation or medical inflation. Future liabilities are therefore real in nature, and assets delivering positive real returns will be of great importance if future goals are to be met.

9.4.7 Equities are expected to keep pace with inflation and expected to outperform bonds and cash over the long term. Historically, equities have outperformed other asset classes resulting in a positive equity risk premium (ERP). In the UK for example, the long run ERP over Gilts is 4% p.a. based on an analysis of annualised real returns since 1899 (Table 11). US data (Table 12) shows that the ERP over Bonds remains at 4% p.a. over a 50-year time horizon increasing to 4.7% over 80 years.

<table>
<thead>
<tr>
<th>Table 11 - UK: Real Investment Returns by Asset Class (% p.a.)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Last</strong></td>
</tr>
<tr>
<td>----------</td>
</tr>
<tr>
<td>Equities</td>
</tr>
<tr>
<td>Gilts</td>
</tr>
<tr>
<td>Corporate Bonds</td>
</tr>
<tr>
<td>Index-Linked</td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>ERP over Gilts</td>
</tr>
<tr>
<td>ERP over Cash</td>
</tr>
</tbody>
</table>

(Source: Barclays Equity Gilt Study 2006)

<table>
<thead>
<tr>
<th>Table 12 - US: Real Investment Returns by Asset Class (% p.a.)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Last</strong></td>
</tr>
<tr>
<td>----------</td>
</tr>
<tr>
<td>Equities</td>
</tr>
<tr>
<td>Bonds</td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>ERP over Bonds</td>
</tr>
<tr>
<td>ERP over Cash</td>
</tr>
</tbody>
</table>

(Source: Barclays Equity Gilt Study 2006)

11 A specific example of a ‘real liability’ would be the financial cost to a parent intending to fund a child’s future education. A university degree in 10 years’ time is expected to cost more, in nominal terms, than it would cost today. A loan commitment of R10,000 in five years, however, would be a nominal liability – the amount of outgo is fixed and not expected to increase as prices increase.
9.4.8 An investor’s risk tolerance or the ability to bear a fluctuation in returns is an important factor in the asset allocation decision. Equities yield relatively higher returns to compensate investors for taking on the additional risk\textsuperscript{12} associated with the asset class. Equity volatility, however, reduces as the period for which the asset held increases. An analysis of nominal returns on the JSE over various holding periods in Figure 18 shows the high volatility of short-term equity returns – a return range from -47% p.a. to over 120% p.a. for one-year overlapping periods.

\[\text{Figure 18 - Equity Return Funnel}\]

9.4.9 The funnel shape of the graph highlights the decrease in the volatility of returns as investments are held for longer time periods. Returns reduce to a far narrower range of between 15% p.a. and 26% p.a. over rolling 20-year periods.

9.4.10 While rolling one year returns are very volatile and regularly show negative returns over a year (Figure 19), returns are always positive for investments historically held for nine years and beyond (Figure 20). And at the very long term end, the average return over rolling 45-year periods is 18.4% p.a.

\[\text{Figure 18 - Equity Return Funnel}\]

\textsuperscript{12} Volatility used as measure of risk.
9.4.11 To summarise, equities have a higher expected return over the long term but are associated with higher short-term risk. Volatility, however, is expected to reduce as the assets are held for longer periods. Based on this insight, one would expect equities to form a large part of the asset allocation strategy for long-term investors.

**Insufficient allocation to risky assets**

9.4.12 Investment professionals (informed by current accepted investment wisdom) would use mathematical models based on a Markowitz or Merton efficient asset allocation framework to develop the optimum asset allocation between different risk assets. Financial advisers may not necessarily deliver the same level of investment expertise, but with a basic appreciation of the risk-return payoff, they play an important role in the asset allocation process for long-term investors.
9.4.13 The behavioural biases (e.g. a lack of understanding or inherent risk aversion) that result in investors allocating a lower percentage to riskier assets can be disastrous for final retirement values. To put a value to this, consider the example of a 35-year-old investor who opts for a Moderate Portfolio as opposed to a Moderately Aggressive Portfolio to house his regular retirement savings. The difference is a targeted 0.75% additional return per annum on the slightly more aggressive portfolio. On a regular investment of R500 p.m. (with contributions keeping pace with inflation), the consequence to the investor at age 60 is R74,000 less capital (in nominal terms) to fund a pension. The total real return (Real Value) drop is R22,000 (R88,000 vs. R66,000) or 15% of the total contributions invested, in real terms. The behavioural finance research referenced earlier in the paper highlights the role advisers can play in helping consumers overcome these biases.

9.4.14 Intricately linked to the value of advice is the impact of framing different options on investor behaviour. Benartzi and Thaler (in Taylor, 2000) proposed that members of defined contribution (DC) funds were more likely to invest in high-risk, high-return assets like equities, if they are shown long-term distributions rather than one-year returns. The results of a series of experiments conducted showed that the median proportion allocated to equities by DC members jumped from 40% (with information provided on one-year returns) to 90% (when shown 30-year returns).

9.4.15 The authors argue that financial advisers are well placed to help individuals overcome their risk aversion biases and select more aggressive investments when appropriate. Such intervention, as per the example above, creates Real Value and can propel investors into Quadrant 1 in the Advice-Value Framework.

Overly conservative regulated asset allocation

9.4.16 Another concern is the excessive conservatism of the investment regulations under the Pension Funds Act. Regulation 28 caps the maximum allowable investment into equities in pension funds at 75%. Retirement savings are invested for very long periods of time which makes short-term equity volatility relatively unimportant. Taking maximum advantage of the available ERP will make a substantial impact on final pensions. The authors believe that the most appropriate asset allocation for (defined-contribution) retirement savings is 100% equity until eight years before the member’s retirement, at which stage some form of life-staging transitioning should begin, ultimately moving the member into an appropriate matching asset for the type of annuity (pension) they plan to purchase on retirement.

9.4.17 The cost of the unnecessarily conservative asset allocation imposed by Regulation 28 can be quantified by comparing the Real Value of a R500 p.m. investment for 35 years (escalating at inflation) in a 100% equity portfolio (Aggressive Portfolio) vs. a 75% equity portfolio (Moderately Aggressive Portfolio) vs. a 60% equity portfolio (Moderate Portfolio). The 75% equity fund grows to R55,000 less, or 22% lower, Real Value Added than the 100% equity portfolio. The 60% equity fund grows to R109,000 less, or 44% lower, Real Value Added than the 100% equity fund.

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13 Refer to the Appendix for portfolio return assumptions.
14 Allowing for life-staging over the 8 eight years prior to retirement from the 100% equity portfolio into a 75% equity portfolio.
15 Again allowing for the same life-staging in the 100% equity portfolio.
These differences are significant and show the high cost of the conservative asset allocation for long-term savings. The authors hope that this issue will be taken into account in the review of pension fund investment regulations in the Retirement Fund Reform process. This has the potential to move consumers further over to the right on the Advice-Value Framework (either in Quadrant 1 or in Quadrant 2).

9.5 Investor Behaviour After a Market Correction

9.5.1 Unfortunately, even consumers with a long term savings horizon tend to pay too much attention to short-term performance or volatility. Consumers panic after a significant fall in stock markets. This section illustrates how costly this can be.

9.5.2 Consider a situation where markets fall by 30% in a short period of time. Sentiment at times like this is generally extremely negative. Volatility is high, bad news abounds (which has generally caused or contributed to the market correction), the commentary in the financial press is generally negative about future prospects and investor confidence is at its lowest. Long-term investors may panic at this point and switch out of their equity holdings into cash to protect themselves from the market volatility and further potential losses.

9.5.3 Any long-term investor who reacts to a market correction by switching into cash after the event, then remaining invested in cash until markets recover past losses before reinvesting in an equity portfolio, would suffer a significant financial cost from this course of action.

9.5.4 To illustrate this in detail, consider an equity investor with a 30-year savings horizon who experiences one stock market crash of 30% after 15 years. This investor switches into cash after the market correction and remains invested in a money market portfolio until the market recovers the 30% it previously lost. Suppose that the market takes six months to recover. After recovery, when investor confidence has been restored and the commentary in the press and ‘in the pub’ is no longer pessimistic, the investor switches back into an equity fund and remains there until the end of her 30-year investment term. The 30-year return to the investor has been eroded by 1.4% per annum, or by approximately 21% of the final maturity amount (i.e. a 21% reduction in final pension, due to one event).

9.5.5 Now consider the case where an adviser is present at the time of the market crash and explains to the investor that she is saving for the long term and that a significant market crash 15 years before her savings end-date is no reason to panic. An adviser convincing an investor to adopt a longer-term view and not switch out of the market into cash at the critical moment would save the investor from the 21% reduction in final value (or 1.4% p.a. lower return over the whole period)\(^{16}\) and adds value to the investor of 1.4% per annum. Given the typical costs of advice detailed in Section 7, around 1% p.a., it is clear that this advice effectively covers the cost of the advice over the full term of the investment.

9.5.6 Do scenarios like this happen in practice? Figure 21 shows the net cashflow experienced by General Equity, Specialist Equity and Asset Allocation Funds vs. performance of the JSE All Share Index. There is a strong correlation. August/September 1998 is one of several points in recent experience where the scenario described above actually occurred.

\(^{16}\) Returns assumed are consistent with the Aggressive Portfolio and Cash returns detailed in the appendix.
In August and September 1998, six-month returns and 12-month returns on the JSE were -30\%\(^{17}\). The mood of investors and the financial press was particularly pessimistic. The reaction of many investors was to disinvest, as can be seen by the significant net outflow following this market correction (circled on the graph). Positive net cashflows only returned to the unit trust industry after the market had recovered its previous losses.

Many investors thus followed the exact behaviour described above which could easily cost them 1\% p.a. in lost return.

Whether consumers made these poor long-term decisions with or without financial advice cannot easily be determined. In some cases, poor decisions may have been made on the advice of a financial adviser, in others, advisers may have been unsuccessful in persuading consumers to take a longer-term view, and in yet others, consumers may have reacted and switched out of equities without any involvement of an adviser.

The key issue is that this is an example of a critical decision point facing a long-term investor where significant Real Value can be added or lost depending on the action taken by the consumer. The Real Value of good advice at this point, when many consumers make the wrong decisions, compares extremely favourably with the cost of the advice.

This can easily be the difference between Quadrant 3 or 4 and Quadrant 1 on the Advice-Value Framework.

\(^{17}\) All Share total return: six months to 30/09/1998 -32.7\%; six months to 31/08/1998 -30.6\%

All Share total return: 12 months to 30/09/1998 -28.4\%; 12 months to 31/08/1998 -32.6\%
9.6 Poor Investor Timing and Fund Choices

9.6.1 Another interesting demonstration of mistakes consumers make is shown by a comparison of the actual return that investors experience in their portfolios to the returns of a systematic investor into an index fund. DALBAR Inc. publishes an annual report entitled ‘Quantitative Analysis of Investor Behaviour (QAIB)’ which conducts this analysis for US investors in mutual funds (unit trusts).

9.6.2 Behavioural finance argues that investors are motivated by fear and greed. DALBAR (2007) explains that a ‘close examination of investor behaviour reveals that as markets rise, investors pour cash into mutual funds, and a selling frenzy begins after a decline’. These poor timing decisions of US investors are very similar to the behaviour of South African investors apparent in Figure 21 earlier in this paper.

9.6.3 Using the 20-year period to 31 December 2006, DALBAR calculates the accumulated dollar amount of $10,000 in total contributions into the average equity fund with the exact monthly investments mirroring the cashflow timing pattern of the average US equity fund investor. This number is contrasted to the accumulated dollar amount of a total of $10,000 invested uniformly (dollar cost averaging) over the same period into the S&P 500 index.

9.6.4 The difference between these two numbers shows the underperformance experienced by the average US equity fund investor through poor timing decisions (relative to simple dollar cost averaging) and through poor choices of equity funds (relative to the index).

<table>
<thead>
<tr>
<th>Table 13 - Average US Investor vs. Disciplined Investor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Results of $10,000 investment spread over 20 years to 31 Dec 2006</td>
</tr>
<tr>
<td>Average Investor</td>
</tr>
<tr>
<td>Dollar cost average into S&amp;P 500</td>
</tr>
<tr>
<td>Dollar cost average into 75% of S&amp;P 500</td>
</tr>
</tbody>
</table>

9.6.5 A further interesting calculation by DALBAR shows the accumulated dollar amount if investing uniformly in a notional fund that returns only 75% of the return of the S&P 500 (i.e. returns 25% lower return than the benchmark every year). DALBAR comments that ‘given that most equity funds outperform … 75% of the S&P … it is unlikely that such a poor performing fund would be selected’. However, a dollar cost averaging investment into this ‘bottom of the pile’ notional fund beats what the average investor actually achieves. This demonstrates that poor timing (as opposed to poor fund choice) is by far the biggest reason why investors under-achieve their savings potential.

9.6.6 Similar calculations have been performed on South African data. The data available has only allowed a comparison of investments into the JSE All Share following the cashflow timing of the average investor with the rand cost averaged investment into the JSE All Share. This strips out the difference between the average fund return and the benchmark return that was embedded in DALBAR’s initial numbers. However, they did show that the effect of the difference between the average fund and the benchmark return was not particularly significant in the light of the poor timing decisions taken by the investor.
Table 14 - Average SA Investor vs. Disciplined Investor

<table>
<thead>
<tr>
<th>Results of R100,000 investment spread over 20 years to 31 Dec 2006</th>
<th>Accumulated Amount</th>
<th>Percentage Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Investor into JSE All Share</td>
<td>R219,996</td>
<td>-</td>
</tr>
<tr>
<td>Rand cost average into JSE All Share</td>
<td>R276,344</td>
<td>26%</td>
</tr>
</tbody>
</table>

9.6.7 Unfortunately the authors have no evidence as to whether these poor investment timing decisions are being made by investors with the help of advice or not. It is most likely that investor cashflow timing decisions are made by the investors themselves, rather than on the advice of their adviser.

9.6.8 However, the key point is that this is an example where good advice can add a significant amount of value. Both US and South African data show that simple, good advice to pursue a disciplined rand cost averaging investment strategy into a fund delivering performance in line with the benchmark (be it an index fund or active fund) can lead to an increase of approximately 25-30% of final savings relative to the actual values currently being achieved by consumers. In relation to the typical cost of advice (refer to Section 7), the Net Real Value of good advice here is clearly positive and hence leads to the difference between Quadrant 3 or 4 and Quadrant 1.

9.7 Decisions Involving Risk Products

9.7.1 ‘Risk products’ refers to products that provide life, disability or other life contingency benefits to the consumer or his or her beneficiaries. Over the last 10 years these products have changed from combined risk and investment products into pure risk products (Dutkiewicz, 2005).

9.7.2 The consumer purchasing a risk product has to make decisions on a number of issues:
- Which risks need to be covered.
- What definition of benefit is appropriate to meet the need.
- What exclusions and conditions are appropriate for the consumer’s circumstances.
- What pattern of premium payments is optimal.

9.7.3 The adviser needs to steer the consumer through these decisions, and in a FAIS environment takes considerable legal responsibility for the advice given.

9.7.4 Direct risk product sales are always a controversial topic. In terms of the Advice-Value Framework, the following mapping can be made:
9.7.5 The full service adviser helps the consumer choose the appropriate product.

9.7.6 The direct sales channel provides some information to the consumer, typically with regards to a limited range of products. The consumer does not get full advice, but trusts that the direct provider is supplying the appropriate product to meet the most important need. This is done with no analysis of the consumer’s needs or of all the options available.

9.7.7 With group benefits, the individual does not receive any advice, but is forced to take out a set of benefits based on the employer’s/fund’s assumption that this set is suitable for the individual. This is an environmental structure that is probably providing a positive Community Value Added.

9.7.8 Finally, there are individuals who do not have any risk cover. This may be appropriate, but an evaluation of, for example, the consequence of disability indicates that having no risk cover often leads to negative Real or Community Value.

9.7.9 The detail of costs and charges in these products will now be examined to highlight the Real Value and Community Value impact of these decisions to purchase a product.

**Premium Patterns**

9.7.10 Actuaries have devised many different premium paying patterns for risk products:

- **Level**: Premiums are level for the duration of the cover.
- **Fixed Escalation**: Premiums escalate annually by a fixed percentage. This percentage was largely 10% during the 1980s and 1990s, typically reducing to 5% in the 2000s in line with inflation reductions.
- **Inflation Linked Escalation**: Premiums escalate annually with a measure of inflation, thus ensuring that the real value of the premium stays constant.
- **Age-Related Escalations**: A more recent development has been to allow premiums to increase in line with mortality increases, i.e. age. The typical motivation for this would...
be that it gives the lowest initial premium which is appropriate for cover that has a potentially short duration.

- **Step Escalations**: A newer invention has been level or slowly escalating premiums with a step jump after a defined period of time. This product is really a series of underwriting-free renewable-term assurances, priced separately.

9.7.11 From the insurer’s point of view, each premium pattern will have a slightly different profit profile, but they will be largely equivalent. However, from the consumer’s point of view, the premium pattern and the reality of the need for the cover will determine the Real or Community Value.

9.7.12 To decide which pattern is best for the consumer requires a financial calculation of the Real Value of premiums paid, not simply a comparison of the initial premiums of various different products.

**Example**

9.7.13 For example, consider a male non-smoker, aged 37, purchasing a level R1m sum assured\(^1\). The initial premium for a level premium policy is 45% higher than for an age-related premium increase policy (R203 per month vs. R140 per month). The adviser will earn 45% more initial commission on this policy sale. The increasing premium is only higher after seven years.

9.7.14 The following graph shows the comparative premiums over 50 years. Illustrated like this, it suggests a strong preference to the level premium which is higher initially, but vastly lower in the future. (It would also be interesting to see the consumer’s reaction to being told that he or she will be paying R2,000 per month in today’s money for a policy when they are 90).

\(^1\) Old Mutual, Class A life, Inflation 5%, Discount Rate 10%
terms up to 20 years. The inflation-linked premium escalation is currently priced almost exactly the same as a 5% fixed-escalation policy. However, consumers of the late 1980s who were routinely sold products with 10% escalations will now attest to how significant the difference between a fixed escalation and an inflation-linked escalation is.

<table>
<thead>
<tr>
<th>Escalation Basis</th>
<th>Initial Premium</th>
<th>5 year</th>
<th>10 years</th>
<th>20 years</th>
<th>30 years</th>
<th>50 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>R203 p.m.</td>
<td>R9,700</td>
<td>R15,700</td>
<td>R21,800</td>
<td>R24,000</td>
<td>R25,300</td>
</tr>
<tr>
<td>Inflation</td>
<td>R143 p.m.</td>
<td>R7,500</td>
<td>R13,400</td>
<td>R21,800</td>
<td>R27,100</td>
<td>R32,500</td>
</tr>
<tr>
<td>Age Rated</td>
<td>R140 p.m.</td>
<td>R7,200</td>
<td>R13,000</td>
<td>R21,600</td>
<td>R27,400</td>
<td>R34,000</td>
</tr>
</tbody>
</table>

9.7.16 Without strong financial literacy, the necessary tools and an understanding of the product mechanics, this evaluation of the Real Value of various options is not obvious. A good financial adviser will be able to show a consumer these relationships to help make a better decision. In this case, the Net Real Value Added to a client with a risk need with a 10-year time frame is R2,700 (R15,700-R13,000) if he is advised to buy the age-related premium plan versus the level premium plan. This is the Net Real Value Added since the figures shown include the cost of advice at the maximum regulated commission.

9.7.17 There is a fallacy often used by financial advisers: ‘Buy this risk product now because it will be more expensive to purchase in a few years’ time because you will be older.’ On a Real Value basis this is incorrect. It is nominally true to say that a policy taken out at age 30 starts out with a premium of R100 per month, while a policy for the same sum assured will cost (say) R200 per month if taken out at age 40. The sources of error in this statement are:
- The consumer has received the benefit of 10 years of cover.
- In the current policy, the consumer is paying exactly the same for the cover at age 40 as the 40-year old will be.\(^\text{19}\)

The valid reason is that the consumer needs the cover now; or the consumer will pass the underwriting tests now, but may not later.

9.7.18 This section has demonstrated the use of the Real Value methodology to assist the advice process for risk products. The issues of premium patterns and commission have only been touched on. There are many more complex issues in risk products that require correct Real and Community Value calculations to determine what is best for the client.

9.8 Good vs. Optimal Advice

9.8.1 The Advice-Value Framework can also be used to illustrate an important point that is generally overlooked in criticism of the quality of financial advice. Three example points are illustrated on the Framework below.

\(^{19}\) Ignoring selection.
9.8.2 Using an example, point A could represent the outcome for a consumer who does not receive advice and does not start to save early enough for her retirement. Point B could represent the advice experience for this consumer after receiving value-adding advice resulting in her saving via a more expensive investment vehicle. Point C could represent an alternative outcome for the consumer, namely saving for retirement via a lower-cost vehicle.

9.8.3 The consumer has experienced a significant increase in value from the advice that moves her from A to B on the Framework. However, C is an even better position for the consumer. The issue of the quality of advice and whether there may be a lower cost product or better advice is one that has resulted in significant comment and criticism of the industry. Point C is a more desirable outcome for the consumer than point B, however, outcome B is still very positive and a significant improvement from the original position (A).

9.8.4 One of the key reasons why a consumer may achieve the outcome in C rather than that in B is that the cost of the advice and/or the product utilised to achieve point C is lower than the cost incurred to achieve point B. For example, the cost of advice for a 25-year upfront commission RA is about 0.7% p.a. (under the current commission regulations). The cost of advice for a unit trust retirement annuity with only as-and-when commission at 3% of each premium is only 0.2% p.a.\(^\text{20}\)

9.8.5 The criticism directed at the point B outcome has almost always ignored the issue of the cost of access to advice. In certain circumstances it is not financially viable for advisers to provide advice to purchase lower cost products, where these products pay commissions/fees at a level that is inadequate to cover the adviser’s expenses. Under such

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\(^{20}\)Refer to section 7.
conditions it may be necessary for the adviser to charge the client additional hourly consulting fees.

9.8.6 This illustration is only meant to highlight some of the issues of good vs. optimal advice. There are numerous complexities that must be considered. For example, conflicts of interest may be present that distort the advice given by advisers.

9.8.7 The ultimate goal should be to move as many consumer outcomes to as far right in the Framework as possible. However, in achieving this, caution needs to be taken not to inadvertently render unviable the business of giving financial advice to those of moderate means, thereby denying many consumers access to advice.

9.8.8 A tough choice would be whether it is more desirable for a limited number of consumers (particularly those with higher amounts of money to invest) to receive advice that results in outcomes such as C, with the majority of consumers’ outcomes remaining at point A, or whether it is more desirable for many more consumers (greater access) to receive advice that results in outcomes such as point B. The concepts of Community Value and Economic Value raised earlier are very relevant here.

9.8.9 This issue is at the heart of the debate between the appropriateness of unit trust based products vs. life insurance based products for regular savings, where different levels of commission are paid within the products.

This concludes the illustrations of the Advice-Value Framework and methodology usage.
10 Conclusions

10.1.1 The purpose of this paper is to demonstrate the value of financial advice. The authors are concerned that the narrow focus on cost, without reference to value, will lead to incorrect conclusions and exacerbate the current savings crisis in South Africa.

10.1.2 A balanced approach is needed. Focus on the fact that excessive costs can erode savings is necessary. But this should not be allowed to lead consumers into destructive behaviour patterns of avoiding investment advice and investment altogether. Furthermore, the complex trade-offs between levels of adviser remuneration and access to advice need to be factored into all debates on the subject of costs in the financial sector.

10.1.3 Hopefully the issues raised in this paper will contribute positively to finding solutions for better access and better quality advice for all consumers.


11 References

1. Alexander Forbes, ‘Member Watch’, Issue 1 2006
27. Life Offices’ Association (LOA), ‘Access Interpretation for Life Assurers’, June 2005
28. MacDonald, R., Presentation to Advisers, September 2007
36. **South African Reserve Bank Quarterly Bulletins**
12 Appendices

12.1 Model Assumptions

12.1.1 A simple compound interest model is used to project future fund values. The model uses long-term average assumptions as set out below.

Table 16 - Model Assumptions

<table>
<thead>
<tr>
<th>Assumption</th>
<th>% p.a.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defensive Portfolio Return</td>
<td>9.50</td>
</tr>
<tr>
<td>Moderate Portfolio Return</td>
<td>10.45</td>
</tr>
<tr>
<td>Moderately Aggressive Portfolio Return</td>
<td>11.20</td>
</tr>
<tr>
<td>Aggressive Portfolio Return</td>
<td>12.00</td>
</tr>
<tr>
<td>Total Product Charges (RIY p.a.)</td>
<td>2.50</td>
</tr>
<tr>
<td>Inflation % p.a.</td>
<td>5.00</td>
</tr>
</tbody>
</table>

Table 17 - Derivation of Gross Returns

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Component</th>
<th>Defensive</th>
<th>Moderate</th>
<th>Moderately Aggressive</th>
<th>Aggressive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>Capital appreciation</td>
<td>9.5%</td>
<td>40.0%</td>
<td>60.0%</td>
<td>75.0%</td>
</tr>
<tr>
<td></td>
<td>Dividends</td>
<td>2.5%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonds</td>
<td>Interest</td>
<td>8.5%</td>
<td>35.0%</td>
<td>25.0%</td>
<td>10.0%</td>
</tr>
<tr>
<td></td>
<td>Capital appreciation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Rentals</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property</td>
<td>Capital appreciation</td>
<td>6.5%</td>
<td>5.0%</td>
<td>5.0%</td>
<td>10.0%</td>
</tr>
<tr>
<td></td>
<td>Rentals</td>
<td>4.0%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>Interest</td>
<td>6.0%</td>
<td>20.0%</td>
<td>10.0%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

Gross return assumptions are based on the expected long-term asset returns (source: Old Mutual). The impact of tax is ignored.

12.2 Modelling the Cost of Advice

12.2.1 Advice and/or commission is one component of the overall cost of a pure endowment, retirement annuity or unit trust product. The other components include charges for administration and asset management fees for example.

12.2.2 The model used includes the impact of commission and/or advice charges only. The gross investment return used is 11.20% p.a., consistent with the Moderately Aggressive Portfolio assumption.
12.2.3 Product charges in respect of commission recovery are set to match commission expenses incurred. The following items are calculated:
   A. the illustrative maturity value of an investment on a gross return basis
   B. the illustrative maturity value of an investment allowing for the deduction of the commission expense

12.2.4 The corresponding cost of advice in RIY terms is calculated as:
   \[(\text{Gross return} - \text{Internal Rate of Return (Scenario B)})\]

12.2.5 The corresponding cost of advice in %RiMV terms is calculated as:
   \[\frac{\text{Maturity Value (Scenario A)} - \text{Maturity Value (Scenario B)}}{\text{Maturity Value (Scenario A)}}\]

12.2.6 The shortcoming of this approach is that it overstates the RIY slightly. Deducting product charges (other than for advice) reduces the fund value available for deducting commission-related charges designed as a percentage of assets. This second-order effect is small and was deemed to be insignificant enough to ignore (sensitivity tests showed that the second-order effect is about five bps for five-year terms reducing to two bps over the longer term).