# Discussion of
# "The Costs and Benefits
# of Financial Advice"

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# Outline

1. What questions are we trying to answer about financial advisors and their clients?

2. What has the existing literature already done (or tried to do) with less awesome data?

3. What does this paper do that…

    … confirms or contradicts existing literature?

    … is new and interesting?

    … can be improved upon or extended?

# Research Questions (1)

- **Goal:** Measure "costs and benefits of financial advice"

- **Complication:** Investors differ along two important dimensions
  - **{Do they seek advice?, Do they receive advice?}**
  - Broker clients are classified as **{Yes, Yes}**

- Broker's advice adds value to investor i whenever:
  - **E[U$_i$({Yes, Yes})] - E[U$_i$({Yes, No})] > 0**
  - This depends on
    - Quality of advice that investor i receives from advisor
    - How investor i would have invested in absence of advice
  - Unbiased advice dominates biased, everything else equal
  - **However, advice that decreases EU of self-directed investors may still increase EU of advisors' clients**
  - *Gennaioli, Shleifer, Vishny (2012)* provide one mechanism

# Research Questions (2)

- We can estimate the causal effect of advice on different portfolio characteristics that impact expected utility:

    - **E[Z|{Yes, Yes}] - E[Z|{Yes, No}]**
    - where **Z** measures expenses, after-fee returns, or risk taking
    - *Passive benchmarks and portfolios of self-directed investors **may** be poor proxies for this counterfactual portfolio*

- Ideal experiment (from the econometrician's perspective):

    - Withhold advice from a random subset of investors who seek it
    - Estimate **E[Z|{Yes, Yes}]** from subset receiving advice
    - Estimate **E[Z|{Yes, No}]** from subset of reluctantly self-directed

- No paper runs this experiment, but *Chalmers and Reuter (2013)* and (the last section of) this paper are able to exploit time-series variation in access to advisors.

# Existing Literature (1)

**Several papers use fund-level data on U.S. broker-sold and direct-sold segments to infer quality of advice:**

- *Bergstresser, Chalmers, Tufano (2009)*:  Broker-sold funds significantly underperform direct-sold funds.

- *Christoffersen, Evans, Musto (2013)*:  Higher payments to brokers result in higher inflows.

- *Del Guercio & Reuter (2013)*:  Underperformance of average active funds is entirely driven by active broker-sold funds, which face weaker incentive to generate alpha than active direct-sold funds.

These papers raise the question whether brokers add enough value along other dimensions to compensate for high fees and low returns... **which is the same question raised in this paper.**

- *Berk & van Binsbergen (2013)*: alpha implicitly assumes investors could have earned risk premia without active management.

# Existing Literature (2)

**Other papers use investor-level data from U.S. and Germany:**

- *Hackethal, Inderst, Meyer (2012)*

  - German bank clients who are more trusting of their advisor generate more revenue for the bank.

  - Do counterfactual portfolios vary with level of trust?

- *Bhattacharya, et al. (2012)*

  - Provide brokerage clients with offer to receive unbiased advice.

  - Utilization rates are low, but $E[Z|\{No,Yes\}] - E[Z|\{No,No\}] > 0$

- *Mullainathan, Nöth, Schoar (2012)*

  - Auditors present advisors with (hypothetical) portfolios, which range from company stock to low cost index funds.

  - Advisers are more likely to introduce or reinforce bad habits than to de-bias investors.

# Existing Literature (3)

**Paper is closest in spirit to Chalmers and Reuter (2013)**

- We use time-series variation in availability of "brokers" to estimate causal effect of advice on DC retirement account portfolios.

- **Regime 1:** Participants can choose VALIC, TIAA-CREF, two others.

- Demand for VALIC is **negatively** correlated with age, salary, education, and employment in b-school or econ department.

- Those predicted to use VALIC who choose TIAA-CREF take much less risk that those predicted to use VALIC who choose VALIC.

- **Regime 2:** VALIC dropped; limited to TIAA-CREF or Fidelity.

- Model used to predict demand for VALIC in Regime 1 is strong predictor of demand for Fidelity TDF in Regime 2 ➔ TDF de facto substitute for financial advice *in our setting*

- TDFs result in lower fees and higher Sharpe ratios, similar risk.

- **Bias?** Demand for VALIC fund is higher when broker fee is higher.

# Empirical Setting

**Analyzes <span style="color:blue">amazing</span> account-level data from "three large Canadian financial advisory firms"**

- Non-bank financial advisers manage 44% of total assets ($390B)

- Authors possess data on **748,287 investors** and 1.5 million accounts between 2001 and 2010, with **$30.9B** AUM in 2010

- Average balance is $57,840 with SD of $19,990

- **Average expense ratio is 2.43% with SD of 0.57%**

- 65% of accounts are retirement savings plans

- **9,569 advisors matched to clients**

- Possess data on characteristics, licenses of 2,200 advisors

- Average advisor earns $80,000 to $120,000 per year

- **Advisors must recommend "suitable" products**

# What Does This Paper Do? (1)

**Provides new evidence on who works with financial advisors...**

- Survey data comparing advised and unadvised:

  - Demand for advice is **positively** correlated with age, income, and educational attainment.
  - Greater scope for advice likely explains why correlations differ from Oregon setting.  However, it also raises questions about the appropriate counterfactual behavior in this setting.

- Advised have greater allocation to risky assets:

  - % equity:            15.0%  versus    6.9%
  - % mutual funds:       9.7%  versus  12.7%
  - % fixed income:      45.2%  versus  80.4%

- Self-reported financial knowledge varies *within sample*:

  - 45.3% as "Moderate"; 5.6% as "High"

# What Does This Paper Do? (2)

**Studies the performance of advisor-level portfolios...**

- Shows that advisor-level portfolios underperform passive benchmark by an amount more or less equal to the (high) fees.

- Also shows underperformance relative to Fidelity TDFs.

- Concludes underperformance is due to high fees.

- Conducts Fama and French (2010) style test for skill using advisor-level data and finds none.

- Relates advisor-level net alphas to advisor characteristics

  - Finds that longer tenure, more clients, more accounts per client, more investments per client, more licenses are **all negatively correlated** with net alphas

  - Begs the question of how advisors attract and retain clients

# What Does This Paper Do? (3)

**Use hazard model to test for learning...**

- Lower (relative) returns predict account closures, as do higher fees within sample of financial knowledgeable investors

  - Why not interact returns with self-reported financial knowledge?

  - Why not include returns and fees in the same hazard model?

    - How much variation is there in fees within an account?

  - Why not control for advisor characteristics?

- Observed expense ratios essentially uncorrelated with self-reported financial knowledge ➔ "lack of financial sophistication is not the driving force behind the high fees."

  - This statement is conditional on having hired an advisor!

  - Self-reported measures may not be capturing relevant variation in investor knowledge/experience/confidence.

# What Does This Paper Do? (4)

**Uses changes in advisors to test for causal effect of advisor recommendations on their clients portfolios...**

- Focus on cases where all of advisor A's clients move to advisor B

  - Distinguish between retirement, death, or termination of A?

- Test whether the portfolios and choices of B's new clients converge to portfolios and choices of B's existing clients

  - Similar to Hvide and Östberg (2012), who use job changes to test for peer effects in trading decisions.

- Find strong evidence of convergence in use of automatic savings plan when B's existing clients already use them. Convergence in asset allocation choices is limited and "economically small".

  - If portfolios vary with client's demographics, may want to test for converge within matched samples of new and existing clients.

# What Does This Paper Do? (5)

**Saving the best for last...**

- Exploit February 2001 regulatory change that reduced supply of advisors in every province in Canada except Quebec ➔ potential to estimate counterfactual behavior without advisors.

- Switch to survey data covering 01/99 to 01/04.

- **Diff-in-diff:** Use of advisors falls ~10% outside Quebec after reform.

- **2nd stage:** Demand for risky assets falls when advisors disappear.

- **Dynamics?** Is post*reform constant between 2001-2004? Is there a decline in 2001 and 2002 that reverses? Is there a movement of advisors from small to large firms post reform?

- Shouldn't those who place the highest value on advisors will be the most likely to seek out replacement advisors?

- Not sure clustering standard errors on households is quite right.

# Extensions?

**Other ways data could be used to assess quality of advice:**

- Compare advisors' own portfolios with those of their clients. Do advisor portfolios tilt more toward low cost, diversified funds?

- Test for portfolio churning after 5-7 years, when trailing commissions on existing funds come to an end.

- Do portfolios vary sensibly with investor risk aversion?

- Do portfolio characteristics vary more sensibly with demographic characteristics within sample of advised households?

- Do advisors with more clients offer more homogeneous advice?

- How do the advisor-level portfolios of the 6% who are terminated differ from the advisor-level portfolios of other advisors?

# Extensions?

**Other ways data could be used to assess potential benefits:**

- Were advised households less likely to sell equity during the financial crisis?

- Are investors with high self-reported financial knowledge more likely to match with advisers with more licenses, perhaps because they face more complicated asset allocation and tax problems?

- Are advised households more likely to refinance their mortgages on favorable terms?

- Do advisors provide tax advice (Cici, Kempf, Sorhage (2013))?

- Of course, once the set of choices extends beyond asset allocation and fund selection and demand is positively correlated with income, education, etc., it begs the question of counterfactual choices....

# Conclusion

- Ambitious paper on a topic of first-order economic importance.

- Authors can and should use their amazing data to write multiple slightly-more-focused papers.

- Ironically, my favorite part does not use these data. Instead, it relies on survey data and the change in regulation in 2001 to argue that advisers have a casual effect on asset allocation decisions.