After The Descent, What Colour The Phoenix?

A detailed perspective on the Canadian Retail Financial Services Industry and the development of integrated wealth management processes

Introduction

This is the first part of a series of documents providing perspective on product, systems, service and brand development, and structural challenges for the retail financial services market place in Canada: these documents will address the development of integrated wealth management systems, service and business processes in the context of current and prospective competitive, regulatory, product and financial market structures, product and financial service distribution, as well as current and prospective market and economic environments; integrated systems represent an important component of the future direction of the retail financial services market place.

The series of documents will form an evolving framework of unique perspectives on key issues impacting the retail financial services' market framework relevant to the context noted above. These documents will develop over time and will deal with a wide array of issues that are also likely to have specific relevance outside of the main context, and are, therefore, intended to serve as a wider "**Thought Pool"**.

These documents are not just contextual structural perspectives, but are intended to be thought provoking and will therefore be relevant inputs to strategic thinking. The overall structure is intended to provide a **"Living Tree"** view of the main industry issues, their components and their contextual relevance.

The "**Thought Pool"** and **"Living Tree"** aspects of the project can be used by firms to develop market research into advisor, consumer, shareholder and executive views on the many issues impacting delivery of products and services in the financial services industry and is intended to be an important source of independent thought on the key issues noted.

This developing resource is also intended to provide a shop window into expertise available within TAMRIS to aid client product, system, business and service process development in the increasingly important realm of integrated wealth management systems and processes.

Level 1 / Part 1 - The imperative of the current crisis

All the issues to be addressed in the project have been given added impetus and urgency by the current and developing financial, market and economic crisis, and should be of interest to those looking to develop their visibility, their returns on capital and viability in the wealth and retirement income planning market place.

Change creates both challenges and opportunities for those best able to adapt and deploy their operational resources.

As such the immediate imperative for the project concerns itself with the current financial, market and economic crisis: this is placing the retail financial services structure under stress, testing its ability to deal with the impact of the crisis on portfolios and investment planning, its culture, its service and product distribution, its processes and its costs, as well as questioning many long accepted methodologies and approaches for managing risk and return at the retail wealth management level.

This crisis has come in the midst of a period when the market place was fighting to establish its credibility in the competitive retirement income planning arena and will most likely lead to challenges to the modus operandi of the financial services industry for a number of reasons[1].

- An increasingly large number of individuals are in retirement, or closing in on retirement than ever before: how their retirement capital and income requirements are being managed could well be called into question in the current environment, creating opportunities for those who rise to the challenge and greater risks for those who cannot.

- World stock markets have fallen between 40% and 50% since 2007 (while oscillating wildly), moving back to nominal levels last seen in 1996 and 1997; price earnings ratios have fallen to levels last seen at the start of the 1980s. This crisis follows hot on the heels of the heavy declines seen between 2000 and 2003, raising the spectre of poor long term market returns for the average investor before costs: add in inflation and real long term returns have been negative for much longer.

    - Investors are often told that stock markets always provide long term returns, yet for many the world over, real capital returns (ex dividends to date) have recently (since the mid 1990s and even since the market peaks of 1987) been historically low.

    - Many sales aids use long term return graphs showing strong upward market returns, usually from a favourably low starting position: this is no longer possible given the sizeable declines since 2000. Investors will find it difficult to forget the disparity and will be more likely to look for realism in marketing going forward.

- Passive buy and hold strategies (static retail portfolios) and long term return assumptions under pinning portfolio selection and investment planning have come under pressure from investors and advisors alike: markets have arguably not been very efficient and market efficiency is central to the logic of passive buy and hold strategies and the many long term return assumptions used by the industry.

[1] It may be valid to ask whether or not the industry has been caught with its pants down.

- While basic fundamentals such as diversification and the general efficacy of market timing are mainstays of most portfolio disciplines, most passive buy and hold strategies fail to address the impact of significant market and economic risk on the management of capital depletion associated with most retirement income planning.

- The impact of volatility/sequence of returns risk on systematic withdrawals from retail portfolio solutions has also been strongly questioned via the introduction of Variable Annuities with Guaranteed Minimum Withdrawal Benefit riders and will continue to be called into question as the current market, financial and economic crisis matures.

    - However, variable annuities are also encouraging investors to take heavy equity allocations to gear into the equity return, exacerbating capital risks: this is impacting shareholders returns and product holders' capital security[2].

- Retirement income planning depends on stability (of structure) and consistency (disciplined application and management of structure) and both would benefit from an integrated disciplined business and service process.

    - Over the last 10 years or more, we have moved through technology, income trusts, commodities, financials, principal protected notes, hedge funds, commodities and many other bubbles as the financial services industry and its clients move from one crisis and fad to the next[3].

    - Hot products/securities are only components of a wealth management solution, they are not in themselves a retirement income planning discipline; a transaction driven culture (buy high[4]) conflicts with a retirement income planning culture (which should sell high).

    - If the retail financial services industry is to promote a brand that states they can be trusted to manage retirement income planning they will need to have a business and service process and culture truly aligned to delivering this outcome[5].

- The industry "appears" to be increasingly interested in managing the retirement income problem via process and this of itself may be an important counterweight to historical transaction based structures.

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[2] It is arguable that Vas with GMWB riders were not designed to cope with current market conditions and this series will look into this issue further.

[3] This type of alternation is not conducive to developing credibility in the eye of the consumer: consumers would prefer greater stability of income and capital security and not less.

[4] Hot products are sold pro cyclical as opposed to counter cyclical. Retirement income planning needs to realise assets to fund capital depletion and to do this effectively it must take advantage of peaks in demand for asset classes. Recycling of products may have helped returns for the industry but the costs associated with this culture have been significant on results achieved by consumers. Can a recycling culture survive both during and post the current crisis?

[5] Obviously, there will be investors who seek to earn a higher return and willing to accept a higher risk and the core structure will need to be able to accept more aggressive options at the margin: an integrated asset and liability modelling and management system would be able to determine an allocation needed to meet retirement income planning needs and allocate excess to higher risk strategies without compromising fundamental financial security.

- A greater focus on process should more closely align industry services and products with the needs of the client for a number of reasons – discussed in later perspectives. Managing process for the less sophisticated advisor/salesperson has advantages for both advisor and client in terms of better management of retirement income planning[6].

- Process implies automation, which implies increased use of technology, leading to both greater uniformity (discipline) and choice (personalisation and flexibility based on common rules and structure[7]), lower costs, greater sophistication and added value[8].

- A transition from a transaction based system to a service process based system is not without conflict and involves significant change in intangibles (not just tangible processes) such as culture and attitudes (expression, perception, recognition), factors also associated with brand recognition.

- Superior processes can greatly benefit sophisticated advisors and portfolio managers for whom advanced processes may be superior to their own, while being simple enough for all advisors to use[9].

- A move towards process will move service costing and hence margins away from transaction remuneration towards one based on process and economies of scale. There will also be fewer transactions[10].

- This greater interest in process also appears to reflect what could be termed a move back towards institutional management of the retirement income planning problem: if this is the case, costs and distribution methods may also be set to evolve further; service based processes will benefit from economies of scale and costs will be based on marginal cost of providing the service as opposed to the costs of a transaction based system.

- The pace of change in product development in the retirement income planning segment of the life cycle wealth management market is heady and momentum is likely to continue to impact product and services development.

- The immense scale of the current crisis will impact demand for financial services for a long period of time: costs will need to be cut to remain profitable, value will need to be enhanced to differentiate brand value, and processes and culture will need to closely mirror the brand promise.

[6] Assuming the advisor/salesperson is already selling high cost products and once the new breed of product is sold the individual investors are not transacted out at a later date for another sales opportunity.
[7] Itself highly dependent on the decision rules integrating asset and liability management and the objectives of systems and services themselves.
[8] The transition to process is not without conflict: process driven products are still being sold through a transaction based distribution framework that requires an upgrade to operate in a process driven environment.
[9] A universal system is a function of design and there is no reason why sophisticated processes that deal with complex problems should not in themselves be simple to use.
[10] The efficiency and efficacy of capital markets does not depend on the amount of transaction based returns intermediaries earn; one could argue that a great many transactions are in excess of that required to efficiently price markets and that more efficient allocation of capital will be achieved through service costs based on the marginal cost of providing a service as opposed to transactions.

  - Organisations will need to integrate processes and resources to benefit from economies of scale: scaling back operations will not on its own lower costs or add value to the brand; this will require improvements in processes. This imperative will enhance competition for integrated, automated, uniform, yet flexible, process driven solutions, and could increase the use of non traditional (lower cost) distribution routes (web based).

  - Organisations that carefully manage their resources and take advantage of the opportunities afforded by change in the market place will reduce the stress on their operations, employees, advisors and clients.

- Costs remain high in the Canadian market place and competitive low cost alternatives that are in situ provide viable benchmarks against which to assess value added. As organisations move towards an integrated service based process and away from transaction based processes, fixed costs of delivering wealth management are likely to come down[11].

- Many of the structures and solutions that were sold to investors to manage risks of equity based investments, while providing return, are also starting to be called into question[12] by events: PPNs (forced into protection event asset allocations), hedge funds (suffering significant declines and redemptions and fraud), and Variable Annuities (where there are now doubts as to the ability of insurance companies to meet the liabilities of GMWBs[13] in the extreme risk events they were designed to deal with). Variable Annuity liabilities may also cause problems with shareholders over the viability of the risk transfer and cost. Far from reducing uncertainty, products appear to have increased levels of uncertainty.

While the economics of financial services would argue for a more sophisticated and competitive financial services market place, with higher levels of automation (integrated business and service processes), uniformity (companies working within and advisors adhering to centralised integrated processes), choice and flexibility (supported by technology, integrated processes and greater understanding of the retirement income planning problem) and lower costs[14] (a result of increased use of technology and integrated business and service processes), there are many significant barriers to change.

The pace of change depends on a number of tangible factors (technology, regulation, competition, consumer income and capital needs and wants, and the impact of declining demand on profitability and fixed costs) and intangible factors (consumer preferences, desires and knowledge base, industry vision, culture, attitudes and brand awareness).

There are as many challenges to the current modus operandi of the retail product/wealth management distribution system in the Canadian market as there are a constraints and barriers to change. As well as looking at the imperatives created by the current crisis, this project of perspectives will look at the fundamental issues impacting the delivery of wealth management, in particular retirement income

[11] The risk of running out of capital that investors are exposed to is exacerbated by high costs: indeed, one could argue that these high costs make many of the new breed of guaranteed products attractive.
[12] If we look at advisor comments in Credo's Retirement Income Planning report, many advisors were critical of PPNs.
[13] Important because GMWBs are effectively disaster insurance contracts – well structured, low cost portfolio alternatives provide better management of income and capital security throughout periods of significant normal market and economic risk because of their much lower costs and more flexible withdrawal structures.
[14] It may seem counterintuitive to believe that uniformity and choice can co-exit

planning and the factors and structures influencing the delivering of stability, consistency, flexibility, value and choice that are synonymous with a retirement income planning brand.

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