After The Descent, What Colour The Phoenix?

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

Part 2 e – Financial/Economic Crisis Related Issues – Products and Product Fads

Products and their transaction, the lifeblood of the retail financial services industry in Canada, are under stress and tighter scrutiny as the current financial, market and economic crisis deepens.

One could argue that many of today's products and transactions have failed. But, have they failed because of their inherent weaknesses or the current crisis, or both? Today's retail financial services industry may not wish to publicly discuss its weaknesses, but privately it needs to address them, and make the necessary competitive adjustments to move forward.

One could also argue that the current crisis is setting the scene for a watershed in the delivery of products and services, in that change is as much a function of survival as it is a wish to improve the solution and the competitive outcome.

- Many products are proving to be far too expensive for Canadian consumers: costs had mitigated much of the long term benefits of investment to the consumer even before the crisis. Even though the structure of the industry depends on the revenue generated by products and transactions, it may no longer be possible to maintain the status quo – for further information on costs please note the specific subject perspective, "Costs and Other Issues".

- Demand for most equity based products is falling, and fixed interest returns are negligible after costs. From a transaction viewpoint, there is little for many investors to currently want to buy and possibly few products that advisors have real faith in.

    - Product and service development will need to focus on products/services/processes/platforms/systems that a) could have retrospectively mitigated much of the risk that has occurred and that could instil confidence and attract demand going forward and b) that could lower costs to make products and services more attractive.

- Material growth in demand for financial services products is unlikely to materialise in the short term and will take some time to recover to the level of capital invested in 2007: investors and institutions are likely to hold higher levels of cash; lower to negative GDP growth equals less savings; continued deleveraging reduces amount of money supply allocated to assets, and many other reasons.

  - Attrition amongst financial service market participants is likely to be significant: the relevance of product/service/platform/system options to the issues of the day and needs of advisors and consumers alike will be critical.

- Many complex products have failed to live up to their promised risk/return profiles:

  - Principal protected notes are now selling low (protection events, some have even altered their mandates to allow participation in markets that have continued to fall) and consigned to return no more than the original nominal capital.

  - Target dated mutual funds with capital guarantees are also exposed to protection type events.

  - Hedge funds have been found wanting (and susceptible to fraud) and have failed to produce their promised risk/return profiles; published return figures for hedge funds should also be viewed with caution as these will exclude the impact of hedge fund collapses.

  - Many products which proposed to manage downside withdrawal risk (variable annuities with GMWB riders) have exposed investors to significant capital losses. These products have also exposed shareholders to significant capital liabilities and declines in share prices, and the probability of companies defaulting on these guarantees is also growing.

- Developing products and service platforms that can provide more stable longer term solutions will be critical.

  - Products and platforms have to be sustainable throughout the market and economic cycle and through all risk events.

- Many products have proven to have had insufficient risk management (alongside too high a cost) and have detracted from rather than added to investors' short and long term financial security.

  - We are most likely at the cusp of a watershed in the way in which financial services are delivered the world over: awareness of this watershed and its implications is critical.

  - If we look at initial reactions with respect to a number of products, we have seen an increase in costs to consumers (further invalidating their use) without the necessary reduction in operational costs.

- There is a limit to the size and duration of equity based risk that any viable return seeking strategy can mitigate and product and service development needs to recognise this; communicating the rationale of product and service solutions going forward will be much more difficult without the right framework. This means that the most efficient and effective method of managing risk is primarily through structure, which requires more sophisticated platforms.

  - There is likely to be a change in the way insurance and hedging is used to manage risk from this point on.

- Many new complex products are difficult to integrate within personalised service based solutions.

  - Product developers are going to have to decide which particular market they want their products to fit into: a transaction based or an integrated service based. If they choose the latter, depending on how the market develops (complex stand alone process driven products or sophisticated platforms capable of incorporating any security or product), they will need to either develop complex stand alone or simple lower cost components.

  - Many products will fin that they do not fit into either a complex complete product objective or the advanced integrated service based platforms.

- Many of today's staple products (balanced mutual funds and model portfolios) have provided little protection from the downdraft and will need to evolve to have a place in the service platforms of the future.

  - Balanced mutual funds where all asset allocation components are held within one fund may find it increasingly difficult to compete with more sophisticated retirement income planning solutions. Model portfolios will also likely be replaced by algorithms and platforms that can construct portfolios from individual components (even down to the individual securities) and provide truly personalised solutions.

  - Structures need to be able to manage capital depletion risks of withdrawals during periods of significant market and economic risk. While the current environment is clearly nor a normal risk event, the duration of the event to date and the size of declines should be manageable within well structured portfolios.

- Margin and leverage: there are likely to be many more negative impacts on the retail financial services industry, not least of which is the relationship between product sales and leverage.

One could argue that the fall out from the excesses and failures of the last 10 years have placed the transaction based retail financial services industry at risk. Does such a business model have validity in a) a market place looking to develop brand credibility in retirement income planning and b) in a market and economic environment that is exposing a transaction model's inability to deliver (a)? These are tough questions given how much is invested in the current business model. Product and service development functions must guard against denial over the impact of current events and accept as soon as possible the new horizon.

Discussion of the differences between transaction and integrated service based frameworks with sophisticated platforms is discussed in specific subject perspectives. Discussion of the liabilities associated with promoting retirement income planning services expectations are also discussed in a specific subject matter perspective.

Decisions

With products (and product remuneration) a mainstay of the retail financial services industry, product and service developers are going to have to look long and hard at a number of key issues.

- Sales objectives are going to have to be redrawn in the light of contracting demand for products and transactions and the increasingly competitive nature of the retirement income planning market: decisions are going to have to be made as to which market place and vision of the future a company is going to align itself.

1. Is it going to continue to commit itself to transactions and transaction frameworks and, if so, will it look to stick to the old ad hoc transaction model or follow a more disciplined and uniform process?

2. If not 1 above, is it going to commit itself to operating within more advanced service based processes and to what extent?

3. How is it going to look to build credibility in the retirement income planning market place and manage the greater brand risk that is associated with a long term client relationship associated with process driven service based solutions?

4. How is the company going to manage the accumulated risk of past product and service practises? More of the same, or a new vision of the future advisors and clients can believe in?

5. In terms of retirement income planning, is the company going to go with complex stand alone products (such as Variable Annuities with GMWB riders) or is it going to go ahead with simple products and securities that can easily fit into an integrated wealth management platform?

6. How is the company going to implement change? What are the costs, time frames and logistics of change? This is much more than a marketing revamp: it will impact the whole business and the whole business structure will need to become involved.

- Changes in sales and business objectives will require changes in processes and distribution frameworks. Even delivering the stand alone complex retirement income planning products requires a higher level of distribution support, training and communication.

- How well does the current product line fit with their objectives; will changes need to be made to costs, to structure, will products need to be simplified or enhanced?

- How dependent and exposed is the product line to the current crisis, to short term market movements, and to what extent will changes to sales and business objectives mitigate those risks? It is important to note that risk management depends on a stable financial and economic market place and transparency over costs and risks of insuring assets in the market place: we currently have neither.

Transaction based products

Products have been developed for a transaction driven market place for a number of reasons: a lack of expertise, technology, process or innovation needed to manage portfolios directly on behalf of individuals; the time it takes to personalise portfolios to the numerous factors without expertise, technology, process or innovation; the demands of capitalism which cannot wait for technology and process innovation to provide optimum solutions; because a transaction driven market place exists and is allowed to operate with varying degrees of freedom (regulation/minimum standards/transparency).

- A high cost transaction driven distribution system has been a vital part of capitalism, channelling capital from consumers to the economy, but it may well have passed its sell by date in terms of its ability to remain relevant in today's financial services and economic market place.

- Products have been designed to be easily sold without the need to address complex relationships between securities, asset allocation and financial needs over time, but it is precisely these relationships that need to be addressed within retirement income planning.

- It is much easier to sell a product if you can define some immediate benefit; past returns or a risk management benefit in a down market etc. Over time such stand alone products - as the need to meet more complex needs and risks has become pressing - have become more complex without necessarily being able to solve the retirement income and capital planning problem; many complex products have tended to promise returns and risk management, but have failed for a number of reasons: high costs, unanticipated outcomes, illiquidity, and the often negative and unintended consequences on the overall balance and risk/return management of the overall asset position.

- Within a transaction driven industry you need to maximise the time spent selling and to minimise the time spent advising; yet, without the technology and innovation in processes, moving away from a transaction driven framework has been impossible.

- Current retirees and the boomer generation have been hit heavily by the current downturn: sorting out the mess, restructuring their plans and their assets is going to take a huge effort; this is only an opportunity for those willing to face the challenge.

Question: could the industry immediately move away from a transaction based approach at this moment in time?

Answer: no, it would need to change the way it operates, it would need to invest time and capital in new systems, in new services, training, investor communication and brand development.

Future of legacy products

While most of the fundamental investment products/securities will continue to have a place in an integrated service based framework - they may need to be simplified, rationalised (fewer funds) and reduced in price - there will be products (and services) that will cede their position in the market place.

The market for retirement income and capital planning and management

As is discussed in investment planning issues, the wealth and retirement income and capital planning and management solution market is likely to split into two main areas: complex stand alone products that do all (but is limited in terms of its ability to personalise) and can be easily injected into the current distribution framework, and the more sophisticated, flexible and more cost effective universal wealth management systems.

> Please note that the leading complex product retirement income planning product, the variable annuity is also coming under stress as doubts arise over the practicalities of managing capital depletion risks via these products. A much simple, more transparent solution is a structural one where the risks are managed by asset allocation (*sensitive to liabilities and cyclical market and*

economic risks), risk preferences (increased exposure to lower risk assets) instead of complex, blanket insurance/hedging (*hedging can still be applied at the margin*) and conservative risk return modelling assumptions.

Time frame of product and process based solutions

One other key difference between a transaction and an integrated process based solution that looks to manage retirement income and capital is the time frame of the commitment. In a pure transaction, the commitment lasts only as long as it takes to sell, whereas in a more complex retirement income planning solution, the commitment is a lifetime. The risks of an individual transaction are lower than the risks of a longer term income and capital risk/return management commitment.

That many of today's products have been exposed in terms of their ability to provide effective long term risk and return management, either through costs or structure, and that their outcomes have fallen far short of the promises and expectations sold at the time of the transaction, means that maintaining a transaction driven solution for the developing retirement income planning market place is sub optimal.

Investors need more than a transaction recommendation to lead them out of the morass of the present and advisors will need more than their current tool box to implement and manage this change.

Products and their place in process

Products in many ways mark the evolution of wealth management and its processes: from the basic mutual fund to the income replacement fund to the more complex variable annuity with a GMWB rider, products have looked to provide simple (cost effective[1] (?)) solutions to the average investor's financial needs.

More often than not, today's products represent a half way house between the total financial solution (the integrated management of total financial assets and total financial needs) that is capable of being delivered through technology and process innovation.

Stand alone non complex products like cash, direct fixed interest securities and equities are easy to incorporate within any strategy; collective simple vehicles like mutual funds (although not balanced funds where units represent holdings in multiple asset classes) and exchange traded funds are also relatively easy to incorporate within most portfolio strategies; the more complex principal protected note, income trust and hedge funds are more difficult to incorporate (but not impossible within sophisticated systems) while variable annuities and lifecycle funds represent retail's first steps towards products that incorporate integrated wealth management processes, and that are effectively (albeit sub optimal) stand alone total solutions.

What many may not fully appreciate is that a sophisticated platform that automates portfolio construction based on risk profiles, asset and liability profiles (the distribution, risk profile, credit and liquidity profiles of assets and specific size and timing of inflows to and outflows from a portfolio), investment disciplines and risk/return modelling (stress tests etc) can also be viewed as a dynamic product that can integrate all products and transactions within a personalised product design. In other words, what used to be the

[1] Smaller investors still cannot access expert management for the average cost of a mutual fund MER. However, rich or small, you can nowadays access an equity allocation for much less via exchange traded index funds.

preserve of portfolio management experts, that took time and money, can be delivered by the average advisors and used by the average online investor.

As such, these systems can also be used to transition from the current product driven environment to a process driven integrated services environment: system assumptions can model can incorporate and adjust for any product or security.

Technology and process innovation will remove the barriers to delivering advanced, personalised, flexible, competitive added value wealth management solutions. While these platforms are not currently in situ, it may only be a matter of time before the market place starts to see their introduction.

Wealth management services and product development departments need to have a plan as to what they intend to do with respect to these potential developments in the financial services market place. No one component of the evolution of the wealth management services market place can be viewed on its own, reference should be made to all factors impacting competition in the market place, as this set of perspectives and though documents intends.

Awareness of advisor processes

New product and service development is going to have to pay close attention to how both stand alone products and advanced service platforms can complement and accommodate advisor processes, while at the same time realising there is greater imperative and opportunity to force change.

This would require detailed research on advisor processes that is not limited to current processes, products and software used. Understanding what an advisor would like to achieve in terms of service solutions and business and service processes is also important.

All advisors have their own processes; some of these processes are more sophisticated than others: the more sophisticated the process, the more a stand alone complex product (such as a variable annuity with a GMWB) will come into conflict with these processes. The more sophisticated and flexible the more likely it will be adopted by advisors.

Future product universe and objectives

But just what will the future product universe look like? The future universe will be defined by a number of factors; regulatory which impacts transparency, standards, accountability; technology which impacts the level of innovation in services, products and processes; the market and economic environment which impacts competition and consumer tastes and preferences.

Changes in regulation could impact the roles and responsibilities of current advisory services from the simple transaction limitations to higher fiduciary type responsibilities. This could likewise reinforce a move towards service based processes and the associated move from transaction remuneration towards service based costing. This would demand greater use of technology further enhancing competitive changes in the market place.

What will ultimately impact the product universe will be the development of the service universe and the systems and processes that deliver and manage the wealth and retirement income planning problems.

The catalyst for such development is likely to be the current financial, market and economic crisis that could well force a significant and deep restructuring of the industry.

It is likely that the current point in time represents a very significant transition period as institutions and advisors move towards more efficient processes and services in order to survive and remain relevant in the market place.

Complex systems and risk management of income and capital security

Managing the accumulation (saving) and depletion of capital (consumption) in a way that manages the risks of capital depletion while creating increased certainty of income and capital withdrawals is complex, but it lies at the heart of the retirement income and capital planning and management problem and hence the key to the solution.

Without sophisticated processes that employ technology to integrate the necessary components of the wealth management solution, the industry has focussed on selling individual stand alone products that were designed to assuage many of the wants and needs of advisors and their clients.

> One reason for a large transaction based industry has been the cost and complexity of managing the wealth management process: most investors do not have the amount of capital or earnings that can acquire access to more sophisticated processes and disciplines; technology and integrated processes are capable of eliminating these barriers.

Critically, retirement income and capital planning and management depend on stability and consistency, as well as the cost of the solution. Investors and companies interested in this segment should be looking to move away from the high cost product of the month to solutions that can deliver the stability and consistency required to meet retirement income planning and capital management needs.

As stated in the perspective on market timing issues, the management of risk to income and capital security can be achieved by one of a number of methods: structure (dedicated portfolios immunised against significant short term risk), hedging (options, futures etc) and risk transfer (insurance based products).

But it is only sophisticated systems that can integrate all the variables (specific and time weighted inflows to and outflows – income and capital - from portfolios; total assets) and the business process components. And it is only sophisticated systems that can maintain the level of order needed to maintain service distribution in the enveloping crisis and financial services' restructuring.

Complex systems and adaptability

Products are notoriously difficult to adapt to changes in markets, tastes and preferences: new products need to be developed to meet the needs and demands of change; complex systems allow all the components of a wealth management solution to dynamically adjust to the variables, meaning a shorter lead in time for nuances in service and risk/return management to be delivered to advisors and clients. In other words, companies can react instantaneously through systems to meet any challenge. How these systems are set up is key and part of successful integration of business and service processes via technology.

Risk and the product/process solution

Understanding risks to the ability of assets to meet financial needs over time and how these can be managed over time, is important for those looking to develop retirement income and capital planning and management products and processes. This is a methodological component and not explicitly a major component of a product and service development perspective, but it is relevant in conducting the moving away from a product to an integrated service process platform.

A wrong turn in the methodology can be dangerous: for example sequence of return risk has been billed as the random risk most likely to impact financial security at any time, when in fact the biggest risks are higher probability cyclical market and economic risks (which are essentially valuation risks). Both sequence of return (effortlessly) and cyclical risks can be effectively managed by structure and planning (combination of modelling extreme risk and maturity structure of assets).

As noted in the perspective on costs, costs are an important component of risk and because of this high costs are a risk to products and services looking to provide retirement income and capital planning and management. Yet, lower costs, greater value and higher or similar margins are not incompatible providing processes are integrated and rationalised and automated and distributed via technology. You do not have to sacrifice return for lower costs, merely existing structure.

Additionally, companies need to think very carefully about the consequences of risk management products and systems. While variable annuities with a guaranteed minimum withdrawal benefit were a success up to 2007, the market fall out since then has hit the financial viability of many companies who had success in this area very hard. How far are the companies of today and tomorrow willing to take long term risks for short term gain in product and service design and development? It is likely that companies will be much more conservative and this conservative stance will impact a move towards a more structured approach to managing income and capital needs in retirement and the accumulation phase.

Opportunities for niche players

With a financial services framework geared towards the service and away from the transaction and the product, there would likely be greater longer term opportunities for niche players.

Summary

The perspectives on investment planning issues, market timing, costs, baby boomer dynamics and advisor roles are all relevant when assessing this product perspective.

Many of the products and solutions developed over the last 10 to 20 years have failed to meet the needs and expectations of investors, in particular those investors dependent on their capital for their short and long term financial security.

That part of the industry committed to developing solutions for the management of retirement financial security is likely to transition away from a transaction to an integrated services based solution. This process is likely to be given added impetus by the current financial, market and economic crisis which may force companies to restructure and move towards a lower cost, integrated, technology based financial services offering.

We are at a clear watershed in the retail financial services market place, the risks for those who fail to adapt is most probably obsolescence: by the time the market and the economy starts to meaningfully recover, those in the industry who have already restructured their business processes and product lines, will dominate the market place.

There is much of the current product offering that will likely be retained, but which will be transformed into leaner and meaner components of dynamic, lower cost, higher margin platform solutions.

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