The Evolution of Investment Advice in Canada: The Next-Generation Advisor

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Keith: Welcome to the Empowered Investor. My name is Keith Matthews and I'll be your host in today's show along with my co-host Marcelo Taboada. Marcelo, how are you today?

Marcelo: As always, I'm super excited about this episode. This one hits right home, so I can't wait to get into it.

Keith: Yeah, this is a great topic. Today we're going to be discussing the evolution of investment advice in Canada. And in particular, we're going to introduce our listeners to what we call the next-generation advisor. We were inspired to do this show by a white paper that just recently came out in the industry—a commentary that came out. So Marcelo, explain to us what was the commentary and why were we inspired?

Marcelo: The commentary was written by Michael Kitsis, who is a legend in the industry. If you are in the industry, you for sure know him. He's a trailblazer in the industry, always keeping advisors up to speed on what's going on in the financial planning and investment industry. He wrote this really great paper called "The Passive Investing Mirage: The Disintermediation of Active Mutual Fund Managers." I know that's a handful in a long title.

Keith: It is, yeah.

Marcelo: But essentially what the article does is it shows how this new proliferation of investment vehicles in passive investing has pushed advisors to go into a next generation of investment advice and has shifted the value proposition from being purely about investment and returns to moving it into a different value proposition, which is a more integrated approach of many different services like retirement planning, taxes, and that type of thing.

Keith: You're absolutely right, Marcelo. Why that hit home for us is essentially because that's what we do.

Marcelo: Exactly.

Keith: The story that he's talking about is the story we have lived, right? And for me personally, this goes back 20, 25 years. When I first started with PWL Capital, we were trying to figure out way back then: do we pick stocks for clients? Do we pick managers for clients? Do we select asset classes for clients? The introduction and evolution of exchange-traded funds allowed us and helped us to say, "You know, at the end of the day, we can build these wonderful portfolios with these passive investment vehicles," which then gives us the time to start delivering services that we felt clients wanted to have. Do you know, Marcelo, that we've been doing that here now for 20 years? That's why this article hit home. We're going to spend today's show elaborating what that means and what it means for investors—the old ways of doing things and then what we think is this next-generation way of doing things.

Marcelo: To me, it's crazy that you did this in the nineties when we were entering the technology boom and it was the era of the superstar mutual fund managers. So that was remarkable.

Keith: You know what I find remarkable? We were maybe 20 years too early because the reality of it is here. You even have Michael Kitsis in the United States talking about it—next generation. But the big demand is right now for this type of advice. So it all starts with index investing or passive investing. So let's start, Marcelo. What is index investing? What is passive investing?

Marcelo: Yeah, that's a great question. I think we got to do it justice and define it because there's a bit of confusion on that term. So passive investing, and I like to use this analogy with people all the time when we're onboarding clients or talking to different people, is essentially when you're driving back home and you hear the market went up two or three percent. They're generally referring to the broad index. In Canada, it's the S&P/TSX 60; in the U.S., it's the S&P 500. So when we say passive investing, this would mean that the person buying this investment vehicle is essentially buying the whole market minus a very small fee. In other words, they are not trying to beat the market; they're just essentially getting exposure to the whole market minus a small fee. So when we say passive investing, it generally means somebody's buying an index and they're not actively trying to do better than the market.

Keith: Yeah, and the proliferation of index and strategies linking to indices has allowed individual investors, advisors, and advisory firms to now start embracing these investment vehicles and introducing them into client portfolios.

Marcelo: Absolutely, yeah.

Keith: So why has that led to the commoditization of investment management? What does that mean, Marcelo?

Marcelo: Essentially, it means that advisors before used to select mutual fund managers or be like a gatekeeper of the mutual funds that went into client portfolios. But with passive investing, we realize that all we have to do is set up the asset allocation so we can get a nice exposure to Canadian markets, international markets. Once we have a portfolio built, we can then focus on other services. By commoditization, it means that we have broad access and it became easier to set up a portfolio instead of having to go into selecting mutual fund managers.

Keith: That's great. I'll go, I think, one step further by saying commoditization also to me means an exchange-traded fund or a passively managed investment vehicle can get you the rate of return of the asset class without having to rely on all of these sets of professionals and stock pickers. So all of a sudden, if your raison d'etre was to be a stock picker and to try to outperform the market, and you've got these vehicles that come in that kind of get you the market return, all of a sudden you're not adding value as that selector. Your services have been commoditized.

Marcelo: Absolutely.

Keith: And with the proliferation—we're talking now for the last 20 years—you can now buy small cap companies in the United States and Canada, in emerging markets, in Europe. You can buy value tilts, you can buy growth, you can buy all of the flavors of the market. Whereas 20 years ago, you needed to go hire an expensive firm to get you that exposure.

Marcelo: Correct.

Keith: So Marcelo, let's talk a little bit about the value proposition and how financial advisors position the value proposition. You did work at Templeton. You saw lots of investment advisors. We've both been in the industry for many years. Traditionally speaking, how did investment advisors position their value proposition?

Marcelo: The typical value proposition—and I saw this on a daily basis when I used to cover financial advisors; that was my job to try to position the Templeton funds to them—but everybody who has a value proposition framed around investment returns typically focuses on picking the right stocks. So the premise is that I have a manager who can pick the right stocks and eliminate the bad ones, identify investing trends. So whether that's technology or a certain industry in the market, they tend to put more weight or underweight depending on what their views are. Then advisors' value propositions to their clients are: "I can select the right mutual fund managers." So a mutual fund manager would be Templeton in that case. We were trying to position ourselves for them to select us as mutual fund managers. The whole value proposition relies on this idea that we can deliver higher investment performance than what the market can give you. You can boil it down to that.

Keith: Yeah, you're right. Whether you were a financial advisor at a large bank, at an independent mutual fund dealer, usually you went and said to your clients, "Trust me, I can choose the best 20 companies for you," or, "Trust me, I can identify the best managers for you," or, "We've acquired research that shows you what trends you should be in, and if you follow our path, we'll get you the best returns possible." And that was, for the vast majority of time, the investment advice value proposition.

Marcelo: Correct.

Keith: How did compensation get in the way here? Or did compensation get in the way?

Marcelo: That's the other thing. I think there's a bit of a divide here into what causes this. Some people say it is the actual beliefs of financial advisors who believe they can beat the market, and therefore, that's why they choose that type of product. And the other camp says it's actually the commissions. Because advisors get a commission from a certain product, because there's not that fiduciary standard where they have to act in the best interest of the client, they will choose the products that pay them the most. And those tend to be the high-fee, high-promise type of mutual funds. I believe there's a combination of those two factors. That's what drives this view that they have to act this way with their clients.

Keith: Okay, very cool. I agree 100%. So Marcelo, let's transition here into this sort of move towards a next-generation advisor, the next-generation advisory services. Now, we've spoken about commoditization, we've spoken about the access of all these investment vehicles, index and passive investment vehicles. So what does the new value proposition look like?

Marcelo: The new value proposition, like we mentioned, advisors realize that they can have access to a great portfolio via an index investing or an index product. So they say, "We have this great portfolio. Now all we have to do is choose the asset allocation—like how much you have in stocks, how much you have in bonds, and in which markets. And then you can focus on things that add a lot of value to clients like planning your taxes with your investing, providing retirement planning and financial planning, cash flow management, and then in the later stages of life, the estate planning." So we go from an environment where the whole premise is we're going to get you higher returns to a very holistic environment where we say the financial or investing equation has been solved. Let's focus on all these things that add a lot of value and bring it all together. So I think that's what it looks like.

Keith: Yeah, you're right. You're absolutely right. And it stems partly because if you're an advisor, an advisory firm in that space where you're saying, "I'm going to build portfolios using these investment vehicles," you're not researching stocks. So there is a time saving in that process. You're also saying, "I'm not getting into the BS market. If things don't work, I'm not going there. And so let me try to find ways to improve clients' experiences." And what do clients need? More than ever before, they need cash flow management, they need retirement planning, they need advice on estate, they need integration, they need advice on tax. And so this is what Kitsis is talking about: next-generation advisor. And this is what we got so excited about because we've been doing this for 20 years. Actually, I say 20 years—we've been introducing new services to clients consistently over the last 15 years and even in the last five years and even the last two years in terms of new ways to help them.

Marcelo: Even my personal experience—I came from an environment where I was constantly working with financial advisors who worked under the old value proposition. And then you come to an environment where all of a sudden you're not under the stress of having to discuss performance constantly because the expectations are set up from the get-go with a portfolio. And then you're talking about things like retirement planning and will reviews and insurance reviews and how you manage together the taxes with the portfolio. And the whole conversation and expectation just changes from the client's point of view as well.

Keith: Absolutely. So Marcelo, let's talk a little bit about the why. We've identified two main themes here about why this shift is occurring. We're going to backpedal a little bit and get back into performance and then we're going to add a new component to it. But why is this shift occurring?

Marcelo: Like you said, there's a few things. But I think one of the main drivers is that we have a plethora of evidence that shows that active investing and trying to beat the market and chase returns is a loser's game. I think that's the best definition of it. There's the SPIVA report that everybody has access to.

Keith: Hang on, Marcelo. What is the SPIVA report?

Marcelo: The SPIVA report essentially tracks and also corrects for survivorship bias. So if a fund disappears, it corrects for this phenomenon. It tracks the performance of active managers against their respective benchmark over long periods of time—so three, five, ten, fifteen years—across different markets. So it's not just saying, "How do they do in Canada?" It's also looking at U.S. markets, international markets, small cap markets, value markets. It's very comprehensive. It essentially gave us a window into what this value proposition that people can beat the market— it just doesn't work.

Keith: You're absolutely correct. We've spoken about the SPIVA reports in earlier podcasts with Ruben. I think one of the interesting things about the evolution of these reports and the evidence—20 years ago, indexing was created and started and sponsored back in the mid-seventies. This is not an overnight success. This is a story that's been going on for now 50 years. However, the investment vehicles—there's more access to them in the last 20 years. People have to live with the process. They have to see, they have to understand how does this work in bear markets? So we've had the bear market of the tech correction in 2000-2001. We had the financial crisis in 08-09. We've recently gone through the pandemic environment and we've gone through lots of blips all the way through 20 years. The evidence is clear. Now it's not something that people can challenge and question. The evidence is clear. And so we're at these tipping points now and this is pretty critical because once an advisory firm says, "I'm now going to start following this evidence-based approach," the dial moves and the dial moves towards clients. What else can I do for clients?

Marcelo: The SPIVA report—they've also expanded their reports and they have not only looked at how the active managers do long term, but they've also looked at what happens when you only pick the winners. So that's another great report they have. They say, "Okay, these are the funds that outperformed the market. Let's see what happens if we only choose them. Let's see what happens after three, five, ten, fifteen years." The numbers are not very encouraging. We'll put up the links. You can check out the reports online, but that's one of the things.

Keith: I think the second major component that's driving the new evolution of advice is demand. For me, that means we are seeing more than ever before demand from 40 to 70-year-olds. That whole age gap—they desperately need guidance on whether they are on track. Are they doing everything they can to make sure that they have a long-term sustainable lifestyle? If they're in retirement mode, is their retirement sustainable? There's this massive need for more information around retirement. Contrast that—go back 25 years ago in the mid-nineties. The baby boomers were this massive group of individuals—they were 30 to 35. They were the ones actually, Marcelo, speculating on dot-com stocks. Every generation goes through their fun and their speculation, but that's what they were doing back then. They didn't have large nest eggs. The group that was retiring back then had a higher chance of having defined benefit plans.

Marcelo: Which is great.

Keith: Yeah. If somebody has a defined benefit plan, the need for retirement cash flow planning, multiple services, tends to be diminished a little bit. This whole group of baby boomers right now—they don't really have the defined benefit that the previous generation had. So they got to sort this whole thing out themselves. That baby boomer generation right now is 55 to 65. The generation right behind that is asking for the same services. I think this is really healthy that it's demand. What it means is essentially you've got financial services firms developing services to meet the expectations, to get ahead of the curve, and to serve clients.

Marcelo: It's great. We've seen a shift—you or I have seen clients come from getting a great service or just a value proposition based on performance. They have done well with other companies, but they come to us and they say there's something missing. We see that trend more and more these days.

Keith: An average client review meeting, Marcelo—you'll spend an hour and a half easily on that review meeting. How much time gets spent on the planning, on organizing financial affairs, on making sure that there's clarity versus the investment discussion?

Marcelo: Typically, if you have a meeting that's an hour and a half, I would say 20 percent of the time is spent on the investment portfolio. We go over the returns, how the portfolio is positioned, reinforce the investment philosophy and what the expectation is going forward, and that's it. We move on. We're not talking about which stock is going to do great. We're not talking about which market will do better or worse. Then we move into what becomes 80 percent of the meeting, which is the retirement planning, where you bring together the portfolio, the taxes, the estate planning, the insurances, how much money they need to retire, is the plan sustainable, what happens if they give their kids a small amount to help them buy a house—all these things. That's 80 percent of the meeting. We've seen a huge change in how people react. I'll never forget—as we have clients who have different personalities and different types—we have a client who we have an extremely good relationship with, but it's always been a very cold and very up-to-the-point type of relationship. I'll never forget the moment we opened the screen and started building the financial plan on the screen and doing some retirement projections. He walked out of the meeting and he said, "Wow. This is really good. I really like this whole process." From then on, I think for him as well, it changed from being a more investing type of—even though we were offering all the services before—it went more from being an investing thing to, "This is a great process where you integrate all these things." That was a good validating moment for me.

Keith: Oh, what a fantastic story.

Marcelo: Yeah.

Keith: So Marcelo, let's talk a little bit about where we're at in the passive evolution in Canada and then let's come up with some conclusions thereafter.

Marcelo: One of the troublesome things, in my opinion, is that even though we're getting all this great breakthrough in the next generation of advice, you look at the flows in the U.S. and in Canada compared to each other and the U.S. is way ahead of us in the adoption of passive investing and adopting this new view of how advice and value propositions are delivered. We pulled a report from PWL Capital, which we're also going to post in the notes, that compares the flows and the market share of passive investing in Canada and the U.S. Just to give you the numbers: here in Canada, the market share for passive investing is 12.9% versus 87.1% for active managers. That tells you that 87% of market participants are still engaged in trying to beat the market despite all the evidence. In terms of how the assets under management or money flows have looked like on the passive side, that's encouraging in Canada. We've seen a growth of 323% from 2011 to 2020, which tells us we're going in the right direction, but we're not there quite yet versus active, which the growth has been 156%. You're seeing passive is growing faster than active, but it's still a very small market share compared to active. Now you look at the U.S., which is where the article was written, and you're seeing the passive market share at 40% versus 60%. What that tells us is that in the U.S. we're seeing a much accelerated growth in terms of people viewing passive as a viable alternative and advisors are more inclined to adopt this type of investing and provide this new generation of advice, which is a great thing. I would like to see that more in Canada for sure.

Keith: Yeah, those are great points and great stats. My suspicion is that given that the U.S. has this investment advisory model called the Registered Investment Advisor, which we'll talk about in a subsequent show, that's really helping. It's a fiduciary. That organization's allowed to charge only management fees, no commissions. That type of organization doesn't really exist in Canada. The model is not permitted in Canada, and it is in the United States. It allows a proliferation of better services, more comprehensive services, and that might explain some of the difference.

Marcelo: What are other observations from your 25 years of experience that you've been doing this? Why do you think we're seeing this huge difference between Canada and the U.S. besides what you just said?

Keith: Marcelo, I'm going to put that one on the shelf because we're going to reserve that for a show coming up, and it's going to be on why Canadians deserve a registered investment advisor. Where I'd like to go right now is really speak about the options that Canadians have right now and why a couple of them are not perfect and why I think this next generation makes a ton of sense. Essentially, you've got different types of groups in Canada that can provide services. You've got portfolio management firms, independent discretionary portfolio management firms that have spent their whole lives trying to figure out how to pick stocks and beat the market. The challenge for investors who work with that group is that it is investment-only. There are no other wealth services. There's no other planning services. So there's a shortfall. There's a gap there in terms of serving clients. The other group that can actually provide all the services—the tax, the planning, the integration—they tend to be independent, but they're working off of a mutual fund platform. While they have all the planning services, their offerings in the mutual fund space are high-fee mutual funds. That's not an ideal model. I think what it comes down to is this new breed of advice firm, which has access to low-cost investment vehicles in the form of passive investing and index. They have the form, they have the platform, they charge very reasonable fees, and then they offer all the extra services. This new breed of advisor—I think there are a dozen firms in Canada. There should be hundreds of firms in Canada, but there are a dozen great firms in Canada. This to me is the exciting thing. There's probably a few hundred advisors that are now really pushing forward in this, but there are 80,000 advisors. We need that to grow. That's what Kitsis' article is talking about. That's the next generation. We're excited because we feel we're there. We're excited for our clients because we think we're doing that. We are in that space and we're moving forward. This is why we're so passionate about everything we do, Marcelo. I know that you wake up every day, and the whole team wakes up excited. What are your takeaways, Marcelo, on this sort of entire topic of next-generation advisor?

Marcelo: It is a fascinating subject. I think my big takeaway is that as people get more informed, and I'm talking about the investment world as a whole, I'm seeing a lot of positive things. The exciting thing is that my takeaway is, because we've been in this new generation trend for a while now, I just feel validated in the way client meetings go. When you get that confirmation every day, it just pushes you to do it more and more. I think as we move forward and people start realizing that this retirement and this new value proposition is what people really need, whether we get more clients or not, that's beside the point. The fact is that a lot more people will benefit from all this, and this benefits society at large. That's my big takeaway.

Keith: Wow, what a great takeaway, Marcelo. Fantastic. The only thing I'm going to add to that is that the good news is that Canadians are going to see more of this evolution of advice. They're going to see it in offerings that they can take up. They will also be able to influence it. For a long time, investors have not had a chance to shape the investment advice industry. I do think that investors and clients have an opportunity to provide feedback. That feedback can really help move a firm forward. It's a wonderful time to be an advisor in this new space, and it's a wonderful time to be a client and an investor in this new space.

Marcelo: Couldn't agree more.

Keith: So with that, folks, that wraps up today's show on the next-generation advisor. We're going to have a few more on this particular subject with a few extra twists. Thanks very much, everybody, and have a great day.

Marcelo: Yeah, and if you follow us on social media, don't be scared to leave us a comment. Or if you have any suggestions for shows, comments, we're always open for feedback. Take care.

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