PRIVATE WEALTH
MANAGEMENT

Unraveling Costs and Creating Change

(Call out to Fix the Confusing Web of **Jargon!**)

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A FOREWORD

Navigating the wealth management industry is complex, especially as new platforms and creations are arising all the time, never mind the confusing cost structures…as an individual this is a massive web of difficult jargon.

Have you ever built an Easter basket for a child and kept adding items? Maybe you see a toy or another candy that they would like and you say to yourself, this will make it better. Then once Easter rolls around and you are putting the basket together, you realize the basket is overflowing and has way too many items! This is the same with investments; each step along the way, the industry has tried to serve clients to buy new products, offer ease of billing and innovations however when you take a step back and look at it as a whole at this juncture; it is an overflowing easter basket of confusion.

There could be value in flushing the industry clean of this complexity, however part of change is driven by knowledge as well as the consumer vocalizing their desires. This article is focused on exactly that and is meant to provide you with a guide of the costs that are in existent today in the industry and to provide an idea for your consideration.

There are underlying reasons, justifications and thoughts behind everything. Kindly know that this article is based on my personal perspective on fair pricing and full disclosure, however I respect that mine is only one opinion on the matter. You can ultimately decide.

I personally believe that costs need to be fully reported in understandable language and easy to find.They should be clear and transparent outlining what you are paying without anything else. Just like what we would expect in other areas of our lives.

First, I will provide a little background on myself, so that you may understand where I am coming from in my review of costs. I am currently in the industry working in my dream role and am highly passionate about being an Advocate and Partner for my clients and have been since 2002. As a professional in the industry, I feel that I come with an interesting vantage point that will serve you in this discussion. I am a Chartered Financial Analyst (CFA) Charterholder, also a Certified Financial Planner (CFP) and finally a Financial Management Advisor (FMA). I have been licensed through most regulatory bodies in Canada including the MFDA, IIROC as well as the OSC; holding positions such as Investment Counsellor, Investment Advisor, Investment Specialist and now as a Portfolio Manager with CIBC Private Wealth. Also I just so happen to be female, which in itself is a rarity in the industry, however I feel that especially after having my daughters (now age 3 & 6) my deep personal care has increased as well as my drive for the betterment of the industry. This has given me increased strength and has made me find my voice on the matter while becoming increasingly vocal.

My desire is by increasing the knowledge of consumers, like yourself, there will naturally be an evolution in the industry towards increasing clarity, which for clients will translate into improved comfort and security in their dealings with this area of their lives.

The regulators recognized that improvements can be made in cost disclosure in Canada and have been making rule changes such as the one that came into effect on July 15, 2013 titled the Client Relationship Model – Phase 2 (CRM2). This introduced new requirements for reporting information on costs among other items, is a great start, however it only required disclosure of the costs associated with advice and not the underlying costs for investment management. I have found that with these changes we have seen increased confusion and not improved clarity. Clients may feel that the printed costs on their statements are in fact what they are paying for, which is typically not correct.

Decisions have many moving parts and change is hard. Over time, I am confident that the regulators will continue along this path and consumers like yourselves, can encourage this change.

Let's delve in. I will keep my review to 4 basic areas that touch the majority of offerings:

1) Management Expense Ratios (MER)
2) Trading Expense Ratios (TER)
3) Bid-Ask Spreads as well as Swap Cost Arrangements
4) Fee based accounts

Then finally, I will turn my attention to outlining what we could evolve towards. This is where my personal opinion will be emphasized and just as a teaser, I believe that charging a fee as a percentage of your assets inadvertently creates a penalty on simplicity as well as a penalty on wealth accumulation. I am an advocate for a flat cost structure based on a client's preferred amount of service not based on the size of their portfolio. The service level preferred is easily determined by a frank and honest discussion. But before we get there, let's review a few current cost arrangements.

PRIVATE POOLS AND MUTUAL FUNDS:

The costs associated with these products are the Management Expense Rations (MER) and Trading Expense Ratios (TER).

A management expense ratio (MER) is the percentage cost charged for the underlying investment management, the operations of the pooled product and potentially the cost of advice, however it does not include the underlying cost of trading as this is covered in the little known trading expense ratio (TER).

In Canada the regulators require both of these charges to be disclosed to investors and you can find them outlined in a document entitled - Fund Facts, typically found on a firm's website. Generally when you are purchasing a pooled product such as a mutual fund, the person giving you advice will provide this disclosure (as it is a requirement), however in those meetings there are many items being discussed and most investors become quite overwhelmed with the amount of jargon.

To add an extra level of confusion, each series of mutual funds and or private pools, have differing MERs even if they have the same investments housed within. As such, you need to be aware of which series you are holding and the reasons why this choice was made for your account.

Finally, the MER has two basic components:
1) cost for advice - otherwise known as the trailer
2) underlying costs - including investment management and operational costs

Generally individual clients do not seek out the fund facts document and because there is so much information during the initial meetings, the document is generally lost in the confusion and filed away or more typically chucked in the garbage.

As outlined above, the regulators now obligate firms to report the 1st component of the MER (or rather the cost of advice known as the trailer) directly on your statement, however this is only around 50% of the overall all-in costs. Personally I do not believe partial disclosure is very useful or very clear for a client.

The 2nd component of the MER (underlying costs for investment management) is not disclosed on your statement and as such is very easy to forget about. You will never see a direct bill for these costs, which may make them difficult to fully understand.

It is somewhat like setting your heating bill to be automatically paid and the statements to be available online like a set-it-and-forget-it way of operating. This likewise becomes invisible.
Both components of the MER are deducted directly from your investments automatically for you.

If instead you received an invoice each year, requesting payment, it would feel VERY different. Imagine receiving an invoice for $45,000 each year from your advisor…would you not start fantasizing over what type of car those funds could buy instead, or how many vacations you could go on (once travel opens back up), or how many charities you could help support?

Now I am not saying advice is not valuable, because I believe it is and my clients would agree. All I am saying is that receiving an invoice, makes the experience more vivid and real, which drives questions and this naturally is a good process. Having said this, it also makes the billing more of a hassle for the clients, so I am also not proposing direct invoices, but rather there should be improved awareness on what is being charged on an overall basis and what the charge is based on. This will only be achieved with more clarity and simplicity.

As briefly mentioned above, the industry has a number of series for pooled investments all created to serve clients in particular manners. (This area is chalk full of jargon, so my apologizes in advance.) In addition to the retail mutual funds (Series A), the industry has a number of other series, which are not uniformly labelled between firms. Here is a quick and dirty (incomplete) breakdown of 4 series:

- Series D (Discount) – built for the discount brokerage platform and do it yourself investors who do not wish to receive advice. Given this preference, they have lower MERs as they are without trailers, however this type of investor needs to factor in the cost of their own time; nothing is free. Many people do not consider this element.
- Series F (Fee Based) – available in the platforms that offer fee based accounts. This series has reduced MER as they do not have a trailer, however the cost for advice is billed separately (outlined in more detail below).
- Series H/T (Tax)– these series have some sort of tax structure, such as a set payout with a component of return of capital. Here you will find MERs which include trailers.
- Series O (Private Pools) – generally only available within the in-house private wealth operation and do not typically have MERs as costs are billed separately for these clients.

The above is quite a rudimentary listing of the various series as there are more series in addition to the ones listed here. One item to note is that in addition to the costs outlined above, each one of these series also has the trading expense ratio (TER) associated with them including Series O.

Typically from my experience within Investment Counsel, the trading expense ratio (TER) is an especially tricky little cost that the private clients may be really unaware of. In my practice while an Investment Counsellor for nearly 9 years at a prominent Canadian firm, I made a point of outlining this cost to clients as they started working with me, however unfortunately this is not disclosed on statements. Since there are typically no MERs associated with Series O, these clients really have a sense that what appears on their statement is their all-inclusive cost; this is simply not true.

Full, clear and simple disclosure should be standardized in the industry to improve clarity in all areas.

EXCHANGE TRADED FUNDS (ETF)

The costs associated with these products are the management expense ratio (MER), the trading expense ratio (TER), the bid-ask spread, at the time of the swap arrangement as well as the commissions associated with the trade if done outside of a fee based account. Within a fee based account, the overlaying fee on the account is also a cost.

Typically an individual client may only consider the listed MER, which might look quite appealing as generally this cost is lower than an actively managed mutual fund especially if you are comparing against one that has the cost of advice built in (such as a Series A). However, other factors need to be considered to understand your overall full cost when purchasing an exchange traded fund (ETF).

Similar to the Fund Facts for mutual funds, there is a document entitled ETF facts, which is a mandatory document for Canadian ETFs. Other jurisdictions do not have this same disclosure and the details are harder to find.

Let's review the main costs (be prepared for more jargon!):

#1: MER/TER:

- Similar to mutual funds/private pools, exchange traded funds have both MERs as well as TER, both of which are explained above.

#2: The Bid-Ask Spread:

- Since the ETF is traded on the open market through-out the day, there is typically a spread to consider, which is the different price for buyers versus sellers. Sellers will receive the lower price (the bid) and buyers will have to pay the higher price (the ask). Meaning that if you instantaneously bought and then sold, the extra cost of the trade would be the spread between these two values. The spread is primarily impacted by three factors:
    a. Liquidity/trading volumes: the ease of trading the underlying holdings (for example the US market is easier to trade than the emerging markets and thereby an ETF based on the US market will have a smaller average bid-ask spread)
    b. Market risks: during times of market turmoil and when the underlying investment market is closed, the bid-ask spread is larger. For instance, during Memorial day, which is an American holiday that falls on May 31st this year, the US market is closed. Even given this closure, a Canadian based ETF with underlying holdings in the US market will trade, this can result in a wider spread.
    c. Costs of putting together a basket and trading: for foreign securities all funds need to be converted back and forth into differing currencies as well there are some nuances in trading such as the UK stamping duty. Having said this, there is positive impact by the presence of Market Makers who can create these types of baskets at a lower cost than a consumer and also work to arbitrage away any pricing discrepancies quite quickly. Both of these sides are reflected in the spread.

#3: Swap arrangement costs:

- In the ETF world, not all ETFs are built the same. For passively invested ETFs, they are usually based on a particular index, however they are able to replicate the index by two main ways:
    a. Physical based – actually holding the underlying securities
    b. SWAP based – by holding a derivative

- With Swap Based ETFs, they have the distinct advantage of converting the earnings (interest and dividends) into unrealized capital gains, which can be very advantageous for high net worth individuals and/or business owners who are concerned with their level of passive income
    a. Note: the Canadian passive income rules introduced in the federal budget in 2018 and effective from 2019, basically results in more taxes. If you have too much passive income within your corporate account, your small business deduction can be restricted.
- The swap arrangement (paired with a corporate class structure) avoids all taxable income and instead simply results in a total return being added to the price of the ETF whereby it will later be taxed as a capital gain when sold.
- (The risks are not outlined in this article, as in my view are minor. I wanted the focus to remain on costs and the article is already getting long in the tooth!)
- If the ETF you are purchasing uses a Swap arrangement; there is approximately 0.30-0.35% in extra costs in addition to the other costs (except for Canadian equity ETFs). This is not reported or included in the MER, so you need to be aware of what you are purchasing.
- Having said this, for the right client within the right structure, this cost can be well worth it!

#4: Finally if you are not holding the ETF within a fee based account, you need to factor in any commissions that might be charged for the trading, which will likely be on the buy and the sale.

FEE BASED ACCOUNTS

Within Private Wealth (both IIROC and OSC licensed individuals and firms - including individuals with the titles of Investment Advisors, Investment Counsellors as well as Portfolio Managers) the main account that you will hold your funds within is what is termed the fee based account or a very similar variation.

These types of accounts strip out the cost of advice and bill the client directly.

One of the advantages of having your fees stripped out in this manner is that it creates tax deductibility of your portfolio management costs in your non-registered accounts.

Having said this, care is needed in this type of account to fully understand your costs. From my experience, you need to know what you are holding to understand if there are any additional underlying costs over and above the fee quoted on the account.

For instance, there are Portfolio Managers, like myself that include absolutely all underlying costs (TERs, custody, swap costs etc.) in their quoted cost structures. These types of Portfolio Managers, will then reduce the costs that appear on your statement to adjust for anything underlying. Having said this, they typically will use the private pools (series O) in conjunction with a portfolio of securities (including at times ETFs), which are directly owned by you and professionally managed by institutional money managers. As such, there are little to no extra costs associated with their portfolios and since their quoted cost structure is all encompassing, you will receive absolute and fully transparent disclosures.

These accounts also can hold other product that may have underlying costs:

- Some accounts will have holdings in F-class mutual funds who have their own MERs and TERs that are additive to the fees that the advisor charges. As outlined above, these are not reported on your statement.
- Also within the investment counselling arena, their quoted fees typically do not include the underlying TERs. Having said this, they likewise will generally use the exact same private pools (series O) and as such there are typically little to no MER associated with them. The additional costs of the TER are not too high; adding 0.10-0.15% to your overall costs, however it does add up:

- For instance, with a $5 million dollar portfolio with an extra TER of 0.11%, the extra charge would be $5,500 per year. Over a 10 year period using a 5% return, this adds up to approximately $70,000 dollars in extra fees that are not part of their quoted costs (albeit typically disclosed in the initial meetings). If you factor in the growth of the portfolio this differential is much larger. No small potatoes!!

The reason why fee based accounts have gained popularity in the industry is the simplicity of the structure and the alignment of the advisor with that of the client in terms of effective management. I am an advocate for fee based accounts, however I believe the fee should be a flat cost based on service as you will soon see.

CONCLUSION AND PERHAPS A NEW WAY

Overall costs in our industry are a confusing. I apologize as even when writing this article, I cringed at how much jargon it contained YIKES!, however I wanted to put pen to paper to help you understand this very important element.

Now, my conclusion. What could it be instead?

Recently I had the luxury of taking a career pause to really consider this question…what could it be? Not what is, not what someone else dictates, but if I were to start from scratch and build the platform from the ground up, what would it look like?

Costs are only one component of what I concluded on, however you will have to stay tuned for the other areas. As for costs, I began to question charging an overall percentage for investment management as opposed to basing the costs on the work being completed. A percentage is our industry's norm at this time, but should it be? Maybe. I feel that this structure creates a penalty on simplicity and certainly a large penalty on being wealthy. Knowing this, there is an element of fair that allows access for smaller investors, to apply a tiered manner universally which feels simple.

Let me give you an example of the wealth and simple comment above, of two fictitious clients, based on real experiences. Let's call the first client Suzy, who after her divorce had a portfolio worth $10 million. Another couple, let's call them Mark and Alice, have two rental/vacation properties located in the US, a family foundation account that they established for charitable gifting and Alice has a professional corporation given her employment as a surgeon. Their portfolio size is $1.7M, but they are in their early forties and still growing.

Using a typical percentage based pricing model, the cost for Suzy might be perhaps 0.74% whereas the couple might pay 1.3%. In dollar terms, Suzy would pay approximately $74,000 per year whereas Alice and Mark would pay $22,000 per year. One component I left out in the above, is that Suzy was very low maintenance, had no complexity and very little requests, so basically she was simple to manage although she had a large portfolio.

In essence, Suzy is paying $52,000 per year more than Alice and Mark but for what you might wonder? I wondered the same thing and the answer is … in this particular instance for nothing. I am over simplifying and over exaggerating, however I wanted to be dramatic, because if you are wealthy, desire normal to low levels of service and are relatively simple, a percentage may not work well for you therefore a flat cost may be better instead.

I will say this with the caveat that at times, wealth does add extra complexity, however not always. Also what is complex is a matter of experience, for instance my clients typically have family foundations, family

trusts, corporations, trusts and other structures that have become second nature to me and are simple. A conversation will determine whether a percentage or a flat cost structure is best in your personal circumstance.

For a client that finds themselves in a cost structure that is not quite right for them and to put the element of wealth into further perspective, let me give you an exaggerated example. What if you were to take your car to Mr. Lube for a simple oil change, however this location decided to charge you on a percentage based on the value of your car. Some people would pay $5 and some people would be paying $6,000 or more for the same service. This may seem ok on paper as the percentage is the same, but in practicality it may create some concern.

I am an advocate for there to be an option for clients between a flat cost structure and that of the traditional percentage based structure.

I focus on offering the flat cost structure in my practice that is based on the complexity and the time spent on caring for the client including taking care of their portfolio as well as their wealth planning. This is a choice and is instead of the costs being tied to the size of their portfolio. This is new for my firm and for the industry here in Canada.

By focusing in this area, my clients are typically larger (at a $5 million average), however the structure is well suited for clients who have over $2 million to invest. At lower sizes, a more traditional percentage tends to work best unless you want a very diminished level of service; this is simply math. Also, as a client nears $20-30 million, we continue to manage them at the pre-established firm minimum allowable percentage.

Currently the industry is not built for this, however where there is a will there is a way. If your Portfolio Manager is creative and works with an innovative openminded forward looking institution who has their clients' best interests at heart, they can make it happen. Personally once I made the conclusion to operate in this manner, my search began and I found my home after evaluating over 10 different institutions with multiple interviews at each. I had to do my homework, but it was worth it!

If you believe that a flat fee might be better given your personal circumstance and your mindset aligns with mine, I encourage you to ask your advisor to consider this structure and to see if it's the right fit for you. I understand that everyone makes different choices and may not share this perspective.

If they are so inclined though, here is how they can do it:

There are two components:

1) The front end cost of my practice is what I have been able to set as a flat cost based on a client's preferred service determined through a number of questions, that I walk them through, ahead of them becoming a client.
    a. Costs are reviewed and adjusted as the portfolio grows and crosses over million dollar increments
2) The underlying money management is a percentage (ranging from 0.29% to 0.38% for active management and much less for ETFs where appropriate).
    a. Hopefully over time this part likewise will change to a flat cost, however for now setting the front end advice costs at a flat fee is a great start.

It is as easy as that!

A NOTE OF THANKS AND GRATITUDE

As mentioned, as a professional in the industry, with nearly 20 years of experience which includes licensing in most capacities, I feel that I can add value to the discussion with a very particular lens. I truly hope this article has been useful to you and I am grateful that you have taken the time to read it.

Finally, I would certainly welcome any questions you may have as I am very passionate in this area and am happy to help you navigate this world. Also, if you have interest in future articles, please email me to be added to my distribution list.

I hope we can change the industry together! Again, thank you for your consideration.

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