WHY ARE SOUTH AFRICANS HAPPY TO PAY COMMISSION?

HYDE PARK: In my last article on Moneyweb, we did a poll asking whether readers would prefer to pay commission or ongoing advice fees for financial products. The results of that poll and my own Twitter poll were fascinating and were contradictory to the drive by regulators around the world to change the way financial advisors are paid.

YOU ARE HAPPY TO PAY COMMISSION

The results of the poll on Moneyweb showed that people are still happy to pay upfront commissions. I realise that the number of participants in the poll were relatively small so we cannot assume that the findings are representative for all investors. The results of the poll were as follows:

The adviser gets an upfront commission paid by the product provider **35.48%**
The adviser gets a monthly fee from the product provider **37.1%**
You pay the advisor an upfront fee directly **16.13%**
You pay the adviser a monthly fee via debit order **11.29%**

In addition to the poll, I also did some market research via Twitter to see how people would like to pay for their financial advice. The findings were very similar to the Moneyweb poll but with a larger number of respondents so in total we have more than 200 respondents.

ASTOUNDING

The results of these two surveys were very surprising to me and left me scratching my head in confusion. The entire global financial planning industry is slowly moving away from commission and other upfront fees but our surveys showed this is not what people want. The newer remuneration models are focussed on annual or pay-as-you-go fees for advice. The logic behind this is that advisors should be incentivised financially to look after their clients over long periods of time. Upfront commissions create no incentive for advisors to service their clients or look after them once the initial money is paid. Many of the disgraceful episodes in the financial planning industry can be attributed to the wrong financial incentives which created a hit-and-run mentality that proved so disastrous to so many unsuspecting people.

As a vocal opponent of upfront commissions, I am not sure what to make of the survey – there are a number of possible explanations.

Lack of knowledge
Most people don't really think about financial planning as evidenced by the vast number of indebted people and countries around the world. This means they won't really apply their minds to issues such as advisor remuneration until they really need advice or until they have been taken for a ride by an unscrupulous advisor. Those who think about their finances might not be aware of the remuneration alternatives and therefore stick with what they know.

The product pays
Many people feel comfortable with commission because it feels as though they are not paying the money – it is being paid by the product provider instead. This is obviously not true but we should not underestimate the role of psychology in our financial decisions. If people paid directly from their

bank account via a debit order or electronic transfer, they would feel very differently even if these amounts were less than the upfront commission.

Little value attributed to advice
I believe that a significant portion of any population want to manage their own affairs and do not want an advisor involved in their affairs. If we look at the short term insurance and online stock broking industries, the providers that deal directly with clients achieve a natural market share of approximately 30%. There is no reason why people would feel any differently about financial products; this means they might be happy to pay an upfront commission as a transaction fee because they don't value ongoing advice.

WHY I DON'T LIKE UPFRONT COMMISSION

I recently met an investor who was sold a 10 year endowment in 2008 by the agent of a large insurance company based in Gauteng. The man is contributing R100,000 per month over 10 years in order to buy a building for his business. The agent charged maximum upfront commission for a 10 year policy which means he earned approximately R220,000 upfront **plus** another R2,500 every month. He would have earned R550,000 in total over 10 years for the pleasure of selling this man the endowment. If the agent was not chasing commission, he would have sold the client a five year endowment which could have been extended indefinitely at no extra cost to the client. The client would have benefitted from lower fees but the agent would not have earned as much commission upfront. To make matters worse, the client's business needed some capital so he needed money from the endowment for a limited period of time. The life assurance company charged him more than R290,000 in penalties to access R2m of his own money. During all this time, the client has faithfully paid R100,000 per month into an investment which has shown no actual growth in three and a half years.

I cannot help feeling that this client would have had a much better deal if upfront commission was not an option.

WHAT IS THE SOLUTION?

I think people should be given a choice whenever they are sold a policy where upfront commission could be charged. Any quotes supplied to the client should show the total upfront and total annual commissions that the client will pay. All the insurance quotes I have seen when researching this story only show how much fees will be paid per month. It is difficult for a client to figure out that 0.365% per month equates to 4.3% per year which actually means R87,600 per year on a R2m investment. So, the quoting system should show them the rand amount of each fee option (upfront vs. ongoing) and the client should sign next to the one they choose.