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Why won't Canadians pay for investment advice?

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It's time for Canadians to get over their hang-ups about paying for financial advice.

I accept some blame for the misunderstandings out there about the cost of advice, and maybe some other financial writers will, too. The net result of our interactions with people is the emergence of a cohort that believes advice just gets in the way of them paying the lowest possible fees.

Most investors are oblivious to the cost of advice and owning investment products – they are the foundational clients of the mutual fund industry. But in a steady trickle, these people are waking up to the negative effect that fees have on returns. Often, it's reading personal finance commentary like this column that gets people thinking.

The result of this awakening is sometimes very positive. Interest in low-fee investments has led to a stunning level of price competition in the exchange-traded fund business. The management expense ratio on ETFs covering the Canadian market can be as low as 0.06 per cent, whereas some of the biggest Canadian equity mutual funds range from 1.89 to 2.7 per cent.

When they see a cost differential like that, some investors can't get out of mutual funds and into ETFs fast enough. Yet, this comparison is too simplistic. ETF fees cover only the cost of running the funds, while mutual fund fees include a hefty portion to compensate advisers and their firms. Those Canadian equity funds mentioned just above? One percentage point of their fees is channelled to advisers and dealers through what the industry refers to as trailing commissions.

Here's where the investment industry bears some responsibility for investor discomfort about paying for advice. These geniuses hid the cost of advice in the fees charged to own mutual funds. These fees are taken off the top of fund returns (investors see net gains or losses), so investors have often been ignorant of them.

For these people, advice has no cost. And if there's no cost, there's no value. The investment industry also has to own up to the fact that many of its so-called advisers are really just salespeople hustling mutual funds. They're financial advisers like the sales guy at the La-Z-Boy store is an interior decorator.

Where my fellow personal finance writers and I went wrong was in hammering away at the cost differential between funds and ETFs, with too little attention given to the fact that not everyone can be a successful, self-sufficient DIY investor. The result, as one adviser told me recently in an e-mail, is that investors believe "that their best path to reaching their financial goals is to focus on the underlying investments at the cheapest possible price."

Low cost is one of the most important attributes in an investment. Pay less, keep more for yourself. But what's your plan, Stan? Do you know what rate of return you need to build sufficient retirement savings? Do you know how long your retirement savings might last once you're done working? Have you made an informed choice between tax-free savings accounts and registered retirement savings plans? Do you have any idea of how to turn your retirement savings into a reliable flow of monthly income?

People contact me all the time to ask questions like these. Many of them are all over the idea of investing in low-cost ETFs. What they lack is a plan that tells them what to do with these tools.

I'm glad to offer a few suggestions to readers, but, increasingly, I'm urging people to get some advice if they have questions they can't answer. If you want to run your own low-cost portfolio, consult a financial planner who charges hourly or flat rates and doesn't sell investment products. If you want someone to take care of everything, seek out an investment adviser who builds financial plans before choosing investments. These advisers either charge a fee of 1 to 1.5 per cent of your assets, or get paid through trailing commissions.

Attention to advisory fees will intensify in the next six months as investors begin receiving account statements that comply with new regulatory requirements to show the annual cost of advice in dollar terms. This improved level of disclosure is an opportunity to start a more mature discussion about fees where we accept the legitimacy of paying for advice when it's needed.

Three ways to pay
Here are three examples of how investors can pay for the financial advice they need.

1. A fee-only financial planner: Pay an hourly or flat fee to discuss a specific issue or develop a full financial plan. No products sold. Many planners are not licensed to discuss specific investments, but they can talk about big-picture issues such as diversification.

2. A fee-based adviser: Pay 1 per cent to 1.5 per cent of your account assets to have your portfolio managed by an adviser who should also provide financial planning. Fee-based accounts may hold stocks, ETFs, F-class mutual funds and more. Product fees are in addition to the cost of advice.

3. A commission-based adviser: You don't pay these advisers directly. Instead, they're compensated through trailing commissions, which are folded into the cost of owning funds and paid directly by fund companies.