

Carving up the costs

Winners and losers in the fight for fees

Competition has contributed to a significant change in the way investment service providers earn their income.

NORMAN SINCLAIR analyses the differentials and reveals some surprising insights on who adds value, and for whose benefit.



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The channels providing ordinary investors with access to managed investments have changed. In the early years, investors chose from a menu of individual unit trusts offered by fund management companies and distributed mainly through tied financial planners. The introduction of the discretionary master trust (or the non-discretionary "fund of funds" master trust) meant that investors then had access to concentrated choices through a single channel that also offered simplified administration.

More recently, the "wrap account" arrived from the US, where it was developed in the early 1980s, and now offers what is claimed to be the ultimate custodial arrangement for individual investors with a more complete set of choices than a master trust.¹ These changes in product delivery channels have occurred against a backdrop of significant structural change in the fund management industry, the financial advisory industry, the fund administration industry, and in the technology that binds them all together.

The purpose of this article is to model the cost impact of alternative product delivery channels on the key participants on both the "demand side" (investors) and the "supply side" (fund managers, financial advisers and product administrators).

The investor represents the "demand" side of the product delivery channel. The conceptual approach adopted in this article is that when investors select a product channel through which to make their investment, they implicitly select various "bundles of cost" that impact differentially on the value of their investment over the investment horizon. The measured reduction in value from an "ideal" (no-cost) investment can be interpreted as the total cost to the investor of that product delivery channel. All costs ultimately affect the demand side and their importance is unambiguous.

On the "supply" side, an analysis of the benefits to service providers is more ambiguous. This arises because the parties on the supply side are not necessarily independent of each other. For example, some fund management groups and financial advisory groups promote master trusts and wrap accounts, and some fund management groups own financial advisory groups and product administrators, and so on. Hence, it is difficult to say whether any party on the supply side is individually better off or worse off.

Because of the complexity of cost disclosures from these types of managed investments, their relatively short history and their convoluted disclosure policies, this paper resorts to a Monte Carlo simulation approach to explore the expected costs and benefits associated with alternative product delivery channels. The intention is to model the general cost implications of defined delivery channels rather than to try to identify the cost associated with any single example. However, in practice, simulation results do provide one form

of “cost benchmark” against which individual product delivery channels can compare themselves.

The product delivery channels examined in the simulation range from conventional multiple unit trusts to the more complex world of master trusts and wrap accounts. A recent alternative has arisen due to changes in the fund management industry and the widespread availability of Internet technology. This product structure is referred to as an “index wrap” and as such it includes all administration, taxation reporting and Internet solutions free (or at a minimal charge). As the name suggests, its major feature is that only low-cost index funds are offered within the wrap service. While all of the index funds may be managed by a single manager, this does not increase the manager risk because index funds are true to style and do not have the same variability in relative performance that characterises “active” funds.²

A number of important results are reported in this paper. In summary, these are that, on average:

- Master trusts could be one of the most costly channels through which investors can access managed investments. On average, they could be approximately 14% more expensive when viewed from the investor’s perspective, after all costs and taxes, relative to the average wrap account. They are also more than twice as expensive as the average index wrap account.
- Financial advisers are approximately 2% better off, in present-value terms, operating under a master trust than under the conventional unit trust structure. On average, in a master trust, they are also approximately 1% better off than under a wrap account.
- “Active” fund managers are the most significantly affected group, due to loss of fee income caused by moving their funds into master trusts and wrap accounts where there is a clear emphasis on gaining access to lower wholesale management fees.
- Product administrators of master trusts are approximately three times better off than the operators of wrap accounts.
- Index wrap accounts maximise the return to investors, after all costs and

taxes, and still leave a healthy margin for value added financial advisers to charge fees. This could be as much as 2% per annum relative to either master trusts or wrap accounts.

COST STRUCTURE ANALYSIS

The disclosure of cost information in public-offer documents in Australia is less transparent than one would expect, given the amount of regulation of financial activity.

Regulators allow many public-offer documents to reveal costs in terms of overall basis points, percentages, dollar values and even as simple qualitative disclosures that a particular cost may exist. Many of these disclosures must be of limited use to the ordinary investor.

This lack of transparency is quite apparent in prospectuses issued by master trusts because multiple levels of cost need to be disclosed to the investor. Consequently, the promoters of a master trust need to disclose the cost of each of the individual underlying managed investments as well as the cost of the administration of the master trust and the cost of any financial advice attached to the product. Needless to say, some do this better than others. The disclosure documents for wrap accounts also need to cover this information but with the addition of any transactional charges that the investor may bear.

Some important costs to investors are ignored. Despite clear regulatory direction on the disclosure of fees and charges, almost all public-offer documents in Australia fail to disclose other cost drivers such as fund brokerage rates and the rate of portfolio turnover. If there is no move towards the disclosure of a total expense ratio (TER), investors cannot be expected to understand the total costs associated with investments that may be recommended to them.

In this paper, costs associated with managed investments have been classified as follows:

General fund characteristics

- Fund characteristics that are applicable to all product channels and will be encountered by all investors irrespective of their preferred point of entry. Distribution

frequencies, amounts and custody charges are of this type.

The costs of fund management

Active retail management fees: The fees charged by the fund manager for retail products offered publicly in a prospectus. These tend to be higher than if the investor accessed the same product through the wholesale channel with an information memorandum.

Active wholesale management fees: The fees charged by the fund manager for managed investments offered under an information memorandum.

Active trading effects: These costs are generated by active management of the underlying fund and can be estimated approximately from portfolio turnover and active brokerage rates. These are typically higher for active managers and this leads to a second-order cost effect because more brokerage is paid. It also leads to a second-order tax effect because capital gains are realised more regularly.

Index management fee: The fee charged by an index fund manager is typically much lower than that charged by non-index managers at both retail and wholesale levels.

Index trading effects: The level of portfolio turnover executed by an index fund manager is a small fraction of that initiated by active fund managers. Hence, capital gains are realised less frequently. Brokerage rates are also lower due to the use of transaction-only brokers, hence dollar brokerage charges to the fund are smaller.

The costs of financial advice

Retail advisory costs: These costs are to be found in the traditional distribution channel for unit trusts and are often known as entry fees and trailing commissions, and are charged by financial advisers.

Master advisory costs: Individual financial advisers using master trusts often receive a fee for the investment amounts that they generate. This may differ in both form and magnitude from the fee

they received from retail products or wrap accounts.

Wrap advisory costs: This is a fee paid by the promoter of the wrap account to the financial advisory group and is often a negotiated percentage of both the annual account fees and asset-based fees. The form and amount of payment under a wrap account contrasts with the standard commissions received from retail unit trusts as entry fees and trailing commissions.

The costs of product channel administration

Master trust management fees:

Typically, the promoter of the master trust levies a fee for product administration computed as a percentage of assets under management in the trust. This may or may not be shared by a financial advisory group.

Wrap administration costs: These costs are often extremely detailed and may include a combination of flat dollar fees, asset-based fees and a large variety of transaction-based fees that reflect investor and account activity.

Index wrap administration costs: This is the cost of administration, reporting and Internet delivery of client administration to financial advisers and investors. This may be free but could be as low as 20 basis points per annum on assets under administration and management.

These costs are bundled differently depending on the product delivery channel selected by the investor. For example:

An investor directly accessing retail funds will incur:

- active retail management fees (not including advisory);
- active trading effects; and
- retail advisory costs.

An investor accessing managed funds through a master trust will incur:

- active wholesale management fees;
- active trading effects;
- master trust advisory costs; and
- master trust management fees.

An investor accessing managed funds through a wrap account will incur:

- active wholesale management fees;
- active trading effects;
- wrap advisory costs; and
- wrap administration costs.

An investor accessing index funds through an index wrap will incur:

- index management fees;
- index trading effects; and
- index wrap administration costs.

The empirical ranges used for these cost types are set out in the Appendix.

SIMULATION METHOD

Monte Carlo simulation is a powerful technique based on the principles of randomisation and the Central Limit Theorem.³ It is particularly useful for understanding relationships between phenomena that may have a known structure but exhibit highly uncertain values and interactions.

The simulation method proceeds in a number of steps:

1. Identify all market, behavioural and cost dimensions relevant to the problem. These are treated in more detail in the Appendix.
2. Establish the range of likely cost outcomes that is consistent with reality. For example, it may be reasonable to assume that active retail management fees are most likely to fall within the range 1.3% to 2% per annum.
3. For each period in the simulated investment horizon, a random return is generated on each of the underlying managed investments. A value is also randomly selected from each of the relevant cost ranges and any financial or behavioural specifications needed in that period are imposed. This cycle is called a single iteration. A large number of these iterations are performed, and at the end of each one, financial outcomes such as return to investor or revenue to providers are measured.
4. At the end of the required number of iterations all of the output results are analysed and summarised.

The simulation evaluates the expected cost

impact on each investor as if they had invested \$100,000 in each of the product structures defined above for a “total life investment” period of 50 years. The power of the simulation methodology lies in the ability to explore events and interactions that have not yet occurred or may never occur. Importantly, within the defined problem structure, they are feasible outcomes and their low probability is captured by the randomisation process. Hence, at the end of this period, it is possible to assess the long-term benefits to investors, financial advisers, fund managers, and master trust and wrap account administrators.

The following outcomes are measured at the end of each 50-year (600 months) iteration:

The annualised rate of return to investors within each product delivery channel:

- under ideal assumptions no costs or taxes;
- after all costs but before taxes; and
- after all costs and taxes.

The present value of the stream of cashflows accruing to service providers in each product delivery channel:

- financial advisers;
- fund managers; and
- product administrators.

The present value of the stream of future cashflows to product providers is scaled by the investor's initial investment of \$100,000. The resulting ratio may be interpreted as a measure of return on “investment” to the provider. Alternatively, from the perspective of the investor, this ratio may be interpreted as a measure of the cost of the service. The exact magnitude of the ratio is possibly less important than its interpretation as a standard of relative cost between providers. The results presented below are based on 50-year investment horizons, each of which is simulated 5,000 times. For analytical purposes, this means that there are 5,000 observations available to form the complete distribution of possible outcomes for the investor and each product provider.

RESULTS

This section of the article presents results for four of the key parties to the alternative product delivery channels described above –

investors, fund managers, financial advisers and product administrators. The latter three providers account for most of the costs that investors bear when selecting “professional management” rather than “do-it-yourself” mode.

The results are structured as answers to simple questions – e.g. “in which product delivery channel is the investor (or service provider) better off?” The answers are not independent, since for one party to be better off, one or more of the others must be worse off. One interpretation of the simulation results is as “boot-strapped” standards against which real-world costs can be compared. For example, if a given investor or service provider in a given delivery channel has a known actual cost of x%, then the simulated cost distributions offer an independent point of comparison for that delivery channel in general.

It is also important to note that while the financial impact on investors (the “demand” side) is relatively unambiguous, the benefits

to the other parties (the “supply” side) are less clear, simply because there is substantial cross-ownership of delivery channels. This means that the individual results for fund managers, financial advisers and product administrators need to be interpreted carefully.

In which product delivery channel is the investor better off?

Investors would no doubt prefer an “ideal” world in which there were zero costs and taxes. Then, wealth could be truly maximised. This “ideal”, but impossible, scenario serves as a useful basis for examining the impact that professionals have on the evolution of investor wealth. Differences between the “ideal” outcome and any other outcome provide a measure of the total impact of costs and taxes. This is another of the luxuries offered only by a simulation methodology.

Table 1 contains the median, 10th and 90th percentile cut-off points for the distribution of annual returns experienced by investors

under alternative simulated product channels on a before-tax and after-tax basis. The results in Table 1 suggest that the conventional product delivery channels are relatively expensive for Australian investors. For example, the estimated before-tax median return from investment in master trusts is 5.1% compared with the “ideal” median return of 9.2%. This difference suggests that, on average, the effective cost of master trusts could be as much as 4.1% per annum. Similar calculations show that the estimated annual cost before tax for retail is 3.02%, for wrap accounts 2.91% and for an index wrap account 0.71%.

In Table 1, the differences between before-tax and after-tax returns are not constant across product delivery channels mainly because the timing and magnitude of operating costs and taxes differ within each product channel. This imparts a second-order effect on the investor’s net investment amount which, through the process of compounding, impacts again on later cost accruals.

Table 2 summarises the estimated cost impact on investors of all product delivery channels. Master trusts appear to be the most expensive delivery channel for managed investments given the cost and behavioural assumptions in Appendix 1.

After-tax cost effectiveness is important because some delivery channels accelerate the realisation of tax liabilities more than others do. For example, funds with more frequent distribution periods and higher turnover will tend to escalate the tax liabilities of investors. The results suggest that, even on an after-tax basis, master trusts are still the most expensive option for investors, although the gap seems to narrow with retail and wrap accounts. This similarity between the three alternatives is almost entirely due to the use of active fund managers in the underlying managed investment. Then, higher turnover realises capital gains faster, and capital gains tax liabilities are realised.

The results in Table 2 provide benchmark estimates of the total expense ratio (TER) that investors could bear when investing through alternative product delivery channels. These cost ratios reflect the usual

TABLE 1 Percentile cut-off points and median annual return to investors in alternative product channels

	Percentile cut-off point	Ideal (no cost, no tax)	Retail trusts	Master trust	Wrap account	Index wrap
Before tax	10%	7.15%	4.13%	3.03%	4.07%	6.41%
	Median	9.2%	6.18%	5.10%	6.29%	8.49%
	90%	12.23%	9.1%	8.0%	9.28%	11.41%
After tax	10%	7.2%	2.75%	2.52%	3.04%	5.12%
	Median	9.2%	4.64%	4.43%	5.01%	7.15%
	90%	12.05%	7.19%	6.92%	7.6%	9.97%

TABLE 2 Summary distribution of estimated cost to investors from alternative delivery structures for managed investments

	Percentile cut-off point	Retail trusts	Master trust	Wrap account	Index wrap
Before tax	10%	3.02%	4.12%	3.08%	0.74%
	Median	3.02%	4.10%	2.91%	0.71%
	90%	3.13%	4.23%	2.95%	0.82%
After tax	10%	4.45%	4.68%	4.16%	2.08%
	Median	4.56%	4.77%	4.19%	2.05%
	90%	4.86%	5.13%	4.45%	2.08%

disclosed costs of management as well as “undisclosed” costs driven by portfolio turnover and brokerage rates at the fund level. On an after-tax basis, only 10% of the simulated outcomes fell below 4% to 4.5% for the usual delivery channels. Any *actual* product delivery channel exhibiting a lower total cost to the investor could be considered highly competitive within the cost structures assumed in the Appendix.

The results in Tables 1 and 2 indicate the superiority of the index wrap account as the least-cost product for investors with the highest before-tax and after-tax returns. In contrast, the master trust appears to be the most costly delivery channel, followed by retail trusts and wrap accounts on an after-tax basis.

Formal tests were carried out to assess the significance of each distribution of 5,000 observations from each of the other simulated distributions. All of these tests showed that the differences across the entire distribution were highly significant between all alternative delivery channels.

The results in Tables 1 and 2 are unambiguous since they impact uniquely and directly on the investor. Lower rates of return are experienced by investors due to the higher costs of delivery imposed by different product delivery channels, irrespective of the party on the “supply” side that levies that cost explicitly or implicitly.

In which product delivery channel are financial advisers better off?

This analysis is based on the distribution of the ratio of the present value of the revenues received from investors by the service provider, scaled by the investors initial investment of \$100,000. A common discount rate was used equal to the expected market return assumed in the Appendix. The present value ratio can be interpreted as a measure of profitability to the service provider due to having the client administered within that product delivery channel. From the investor’s perspective, this ratio can also be interpreted as a measure of cost.

These results are presented in Table 3. On average, after all costs and taxes, it is clear that financial advisers are almost 2% better

off under a master trust structure than they were under the conventional retail unit trust structure. On average, they are also better off than they would be operating under a wrap account by almost 1%.

The results in Table 3 have an alternative interpretation. They support the proposition that the average client whose adviser recommends a master trust as the delivery channel for managed investments could be approximately 2% worse off than under the conventional structure. If this is so, then

perhaps the conflict of interest that has always plagued financial advisers is just as pronounced under the opaque fee structures that characterise master trusts and wrap accounts.

Formal tests were carried out to assess the significance of each distribution of 5,000 observations from each of the others. All of these tests showed that the differences across the entire distribution were highly significant between all alternative delivery channels.

TABLE 3 Percentile cut-off points and median annual return to financial advisers in alternative product channels

	Percentile cut-off point	Retail trusts	Master trust	Wrap account
Before tax	10%	11.78%	12.05%	11.48%
	Median	16.21%	16.84%	17.72%
	90%	27.11%	26.79%	32.07%
After tax	10%	10.0%	11.15%	9.75%
	Median	12.86%	14.99%	14.14%
	90%	18.63%	22.07%	22.54%

TABLE 4 Percentile cut-off points and median annual return to fund managers in alternative product channels

	Percentile cut-off point	Retail trusts	Master trust	Wrap account	Index wrap
Before tax	10%	29.6%	14.3%	16.85%	10.56%
	Median	43.96%	20.88%	25.63%	16.98%
	90%	79.79%	36.41%	48.06%	34.13%
After tax	10%	23.48%	12.94%	14.26%	8.43%
	Median	32.85%	18.1%	20.35%	12.91%
	90%	51.69%	28.53%	32.56%	23.52%

TABLE 5 Percentile cut-off points and median annual return to product administrators in alternative product channels

	Percentile cut-off point	Master trust	Wrap account	Index wrap
Before tax	10%	24.28%	10.12%	5.41%
	Median	35.94%	14.39%	8.59%
	90%	62.7%	23.46%	17.11%
After tax	10%	21.83%	8.98%	4.28%
	Median	31.19%	12.46%	6.52%
	90%	49.57%	18.26%	11.8%

TABLE 6 Cost and behavioural ranges used for simulation parameters

Cost dimensions	Minimum	Maximum	Other details
General:			
Iterations			5,000
Available funds			10
Months			600
Market return			10% per annum
Market std dev			18% per annum
Income tax rate			47%
Capital gains tax rate			47%
Total initial investment			\$100,000
Fund beta risk	0.40	1.6	
Investor activity:			
Switches	2% of fund value	5% of fund value	100 switches
Deposits	2% of fund value	5% of fund value	100 deposits
Withdrawals	2% of fund value	5% of fund value	50 withdrawals
Fund features:			
Distribution frequency			Quarter or semi-annual
Distribution amount	2% of fund value	5% of fund value	Taxable income
Custody fees charged	0.05% pa	0.15% pa	Charged monthly
Fund costs:			
Active retail mgt fee	1.3% pa	2.0% pa	Charged monthly
Active wholesale mgt fee	0.65% pa	1.25% pa	Charged monthly
Index mgt fee	0.20% pa	0.60% pa	Charged monthly
Trading costs:			
Active portfolio turnover	60% pa	100% pa	
Active brokerage rate	0.30% per trade	0.60% per trade	
Index portfolio turnover	2% pa	5% pa	
Index brokerage rate	0.05% per trade	0.15% per trade	
Advisory costs:			
Retail funds entry fee	1%	5%	Of initial and additional
Retail funds trail commission	0.35% pa	0.60% pa	Of fund, paid monthly
Master trust entry fee	1%	5%	Of initial and additional
Master trust trail commission	0.50% pa	0.70% pa	Of trust, paid monthly
Wrap "trail commission"	50% pa	75% pa	Of annual account fees plus asset-based fees.
Master trust administration:			
Master trust management fee	1.25% pa	2.0% pa	Of trust, paid monthly
Wrap administration:			
Monthly account fee	\$15 pa	\$25 pa	Flat fee per account
Asset-based fee	0.7% pa	1.2% pa	Charged monthly
Transaction fee	\$25	\$75	Per transaction
Cash withdrawal fee	\$10	\$20	Per transaction
Cash deposit fee	\$3	\$6	Per transaction
Index wrap administration:			
Asset-based fee	0.20% pa	0.20% pa	Flat charge, per month

APPENDIX

A number of additional behavioural and cost assumptions were required in the simulation. These are:

- Entry fees, where appropriate under a particular product delivery channel, are charged on initial and all additional applications.
- Income tax implications for the investor are dealt with at the time of the taxable cashflow. The net-of-tax cashflow is reinvested immediately. This means that tax liabilities are permitted to "leak" from the investors account throughout the simulation period.
- Only one transaction type (deposit or withdrawal) is assumed to occur in any investment in any month excluding a switch.
- The distribution frequency of the master trust is assumed to be the same as that of the underlying funds in the trust – hence all income distributions for master trusts are likely to be quarterly since this is the minimum frequency assumed for the underlying funds.
- The amount of income to be distributed is drawn randomly. However, when compared to the movement in total fund value over the period this is taken to imply a capital gain/loss for the period. Capital gains are assumed realised according to a random turnover rate and then distributed. Capital losses are carried forward to the next distribution period. Both income and capital gains distributions are assumed to be immediately reinvested net of tax.
- Transaction charges in the wrap are assumed levied on all buy/sell decisions with a fee for both cash and fund transactions. A switch between funds is assumed to attract only a transaction charge.

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The results suggest that there is a higher level of profitability for financial advisers working within the master trust product delivery channel. To the extent that other parties such as fund managers, master trust sponsors and even wrap providers may “own” the financial advisory group, these results cannot be interpreted in isolation. An obvious insight is that a fund management group that owns the master trust together with the financial advisory distribution channel would be maximising its share of the investors “dollar spend” on financial services.

In which product delivery channel are fund managers better off?

Results for the distribution of “return” to the fund manager are presented in Table 4.

The results in Table 4 support the proposition that fund managers are much better off under the conventional retail delivery channel. There, they received higher management fees and their financial advisers received entry fees and trailing commissions as specified by the fund manager in the prospectus. However, as shown in Table 3, financial advisers were not as well off under that delivery channel. This result is consistent with the empirical observation that there has been accelerated growth recently in the use of master trusts by financial advisers.

Table 4 also shows, as expected, that an index manager is the cheapest service provider, consistent with that investment style and the lower fees charged.

Formal tests were carried out to assess the significance of each distribution of 5,000 observations from each of the others. All of these tests showed that the differences across the entire distribution were highly significant between all alternative delivery channels.

In which product delivery channel are product administrators better off?

Table 5 shows that in relative terms, the administrator of a master trust receives a substantial premium over the operators of wrap accounts and, as would be expected, index wrap accounts. This could be as high as a factor of three.

Taken together with the results for financial advisers in Table 3, this indicates that there

is a major force operating in the Australian market when financial advisory groups own the master trust channel. Superficially, this implies a major loss to the fund manager – but only to the extent that the fund manager does not own both the financial adviser and the master trust channel. Fund management groups that follow this multi-level strategy will clearly recapture the largest part of the dollar spend incurred by the investor.

All of the distribution differences in Table 5 are also highly significant using formal statistical tests.

CONCLUSIONS AND IMPLICATIONS

The principal findings of the simulation study are:

- The estimated cost to the investor is relatively unambiguous and the simulation results indicate that the after-tax cost of all conventional product delivery channels could lie in the region of 4% to 5% per annum. This contrasts with the cost of an index wrap of around 2% per annum.
- Master trusts appear to be the most costly vehicle for investors to access managed investments. This could be approximately 14% more expensive when viewed from the investors perspective, after all costs and taxes, relative to the wrap account. The cost to the investor of a master trust is also more than twice the cost of an index wrap account.
- Financial advisers are approximately 2% better off, in present-value terms, operating under a master trust than under the conventional unit trust structure. They are approximately 1% better off than under a wrap account.
- Active fund managers are the most significantly affected group due to loss of fee income caused by moving into master trusts and wrap accounts with their emphasis on wholesale rates.
- Product administrators of master trusts are approximately three times better off than the operators of wrap accounts.

The simulation results presented in this article considered the cost of alternative product delivery channels from the perspective of the investor on the “demand” side, and the various service providers on the “supply” side.

On the supply side, when interpreted independently, the “winners” are clearly financial advisers operating via master trusts and the administrators of those master trusts, while the “losers” are clearly the fund managers. There is not strict independence on the “supply” side because of multiple interdependencies in the “ownership” of product delivery channels.

Fund managers

Fund managers have been in a perpetual struggle for a share of the fee income from investors. For many years, these fees have not changed and may have even diminished as the practice of rebating entry fees became more widespread. Fund management companies can recapture their share of the investor dollar spent on managed funds by integrating with financial advisers that operate via master trusts.

Ironically, this suggests that over time the original relationship between fund managers and financial advisers will be restored – but their services will now be packaged within a master trust offering a variety of managed products. With this strategy, revenues lost on fund management are regained through administration costs and fees from financial advice.

Financial advisers

The needs of the client will always remain paramount. However, the results suggest that serious conflict of interest arises if clients are directed into master trusts in which both the financial adviser and the administrator win at the investor’s expense. Financial advisers need to look for more professional ways to generate income that demonstrate “value added” for the client and that use the full range of available managed investments. The results suggest that financial advisory groups (particularly those with established master trusts) could present attractive targets for predatory fund management groups seeking to regain a larger percentage of the investors expenditure on financial services.

Regulators

The major implication for Australian regulators and industry bodies concerns the disclosure of fees and charges by providers of financial services.

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In the same way that other financial institutions are required to estimate "effective rates of interest", it is important that investors are given a reasonable insight into the impact of *all* costs on their intended investment plan. An obscure statement of basis points or percentages does not fulfill this requirement. Instead, financial advisers and product administrators ought to provide a worked example of the total dollar return expected over a given investment horizon under specified assumptions.

NOTES

1. The differences and similarities between discretionary master trusts and wrap accounts are well known:

- Wrap accounts offer more wide-ranging investment choices to investors that

include managed investments, direct shares and bank deposits, among others.

- Wrap accounts have been portrayed as custodial services since the investors register all assets in their own names. In comparison, master trusts use a trustee to hold the underlying securities on behalf of the investor.
- Both products provide consolidated investment reports to the investor and that simplifies general reporting and taxation matters.
- Both products provide financial advisers with a simple solution for client reporting, leaving them to focus mainly on their client relationship.
- Both products exhibit quite complex cost structures that limit the extent to which the investor can assess the full cost of investing at the outset of the investment.

2. Index funds are "zero-alpha" investments in the sense that they do not try to outperform the performance benchmark in the same way that "active" funds do. For a discussion of the concept of alpha, see Sinclair, N.A., 1993, "Alpha – the financial pimpernel?", *JASSA*, September. The concept of value-added (ex post-alpha) is explored further in Sinclair, N.A., 1999, "Index or active? Some myths and realities of value added", *JASSA*, 1, Autumn.

3. The Central Limit Theorem states that the distribution of the sum of any set of independent random variables will converge to a well-behaved normal distribution that can be defined completely in terms of its mean and variance. This statistical attribute helps simplify the interpretation of simulated results despite different distribution properties of individual inputs.