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The Gamma Factor and the Value of Financial Advice

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The Gamma Factor and the Value of Financial Advice

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Abstract

“If it has a price, it must have value”

This study, based on a new Canadian survey and adjusting for the causality issue, reconfirms the positive value of having financial advice. As in our earlier paper, the discipline imposed by a financial advisor on households' financial behaviour and increased savings of advised households are key to improving asset values of households relative to comparable households without an advisor. Benefitting from a subset of participants in both surveys, dropping an advisor between 2010 and 2014 was costly: those households lost a significant percentage of their asset values while the households who kept their advisor have gained in asset values.

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1. Introduction

Financial institutions frequently describe and advertise the benefits of having a financial advisor. Industry participants routinely claim that this advice contributes by, among other things, increasing the rate of return on investments, improving savings and investment behaviors, selecting appropriate financial products, improving the tax efficiency of savings, optimizing asset mix for personal circumstances and risk tolerance, and ultimately increasing financial confidence and peace of mind. While these benefits may be valid, are the effects of advice observable and measurable? Is financial advice worth the cost?

Not surprisingly, the impact, or value, of advice has drawn considerable public attention. Positive industry claims are met with public skepticism, particularly when the markets show considerable volatility or downward results. By its nature, advice would seem to be a complex set of interrelated processes.

The academic literature remains relatively scarce about the net worth of advised investors, observed differences in portfolio composition and the cost, risk and consequences of advice. The type and volume of reliable data required to measure the various values or impacts of advice are hard to obtain. Overtimes, three factors were identified to estimate the net return on the value of advice. By far, the factor most refer to is the alpha factor where the performance of an investment is compared to a market index. Advice aim at over-performing the market which is realised by few financial advisors. Lower net return with financial advice relatively to non-advised households has been mentioned in many studies. Others have demonstrated the contrary. For the industry, advised savers received a net median returns that were about 3% points higher than non-advised participants. This is not negligible, although, how much of this is from better stock picking is unclear. Balanced market portfolio advice, sometimes associated with the beta factor, seems also to have a positive effect, albeit marginal for some. Recently, as reported by Hermansson and Song (2016), new studies identified value in advice that prompted diversification and improved savings discipline, better disciplined behavior facing market volatility rather than in returns. This is refered in this study as the gamma factor.

With a new Canadian survey, this current study reaffirms the strong postive effect on the amount and the value of assets of advised households. We were able to avoid the causality issue present in

this kind of study to identify if financial wealth attracts advice, or advice impact financial wealth, Furthermore, with a subset of households surveyed in both 2010 and 2014, we show that keeping your advisor was largely beneficial relatively to those who dropped their advisor after 2010 (the survival issue). In short, this research provides the foundation for an exceptionally strong key message about the value of financial advice.

Limits have to be stressed, however, with our results. Although, we control for many factors, we recognize that the positive effect of having the services of a financial advisor is overestimated by the lack of households characteristics, such as, for example, a willingness to invest attitude compare to an impatience to consume, a major factor that is difficult to measure with an household survey.¹

Following the introduction, section 2 concerns the updating of the previous study. Section 3 presents the results of a new literature. In section 4, the value of advice is revisited while in section 5, we discussed the survival principle by comparing the behavior of households present in both 2010 and 2014 surveys. Conclusions and suggestions for further research close the paper.

2. Updating the Previous Study

The Previous Study

In a previous paper (Montmarquette and Viennot-Briot, 'The Value of Financial Advice,' *Annals of Economics and Finance*, 2015, 16-1, 69-94), we addressed three questions:

- 1) What are the determinants of having a financial advisor?
- 2) What is the economic impact of having an advisor on household investment asset value?
- 3) How does financial advice work?

That study is based on a pair of detailed surveys conducted on a single, large set of working-age Canadian households about six months apart, in December 2010 and June 2011.² The

¹ Those characteristics are better measured in field experiments for an example associated with investing in human capital. See Johnson C., & C. Montmarquette, "The lack of Loan Aversion among Canadian High Schools Students", *Canadian Journal of Economics*, 2015, 48-2, 585-611.

² In December 2010, Ipsos Reid was commissioned by Power Financial Corporation to conduct an Internet-based survey on the financial situation of Canadian households. A total of 18,333 working-age households participated; 10 505 were retained after adjustments for out-of-scope and incomplete answers. Sponsored by

sample totaled 3,610 respondents who were the primary financial decision-makers or were involved in the household's financial decision-making. All participants were between 25 and 65, had at least \$1,000 in financial assets and a household income of less than \$250,000. The surveys captured significant detail about the participants':

- financial situations,
- socio-economic background,
- financial literacy,
- behavioural tendencies,
- financial objectives,
- saving rates, type and tenure of advice, as well as their perceptions and satisfaction with their situation and financial advisors.

It should be noted that the financial and economic data are for fiscal 2009. In this survey, 1,785 participants (49.4% of the total) declared having a financial advisor, while 1,825 respondents did not have an advisor.

Question 1: What are the determinants of having a financial advisor?

Against the first question ("What are the determinants of having a financial advisor?"), as expected, three relevant factors positively affect the probability of having a financial advisor:

- income level,
- the capacity of the household to save and
- the age of the respondent.³

Power Financial, CIRANO designed and conducted a follow-up survey focused on assessing the value of advice in June 2011 that reassessed the 10,505 respondents from the original. A total of 4,978 observations were collected; of these, 3,610 were retained after adjustments for out-of-scope, incomplete, and inconsistent answers. CIRANO administered both survey datasets.

³ Asset levels were not considered as a determinant of having (or not having) a financial advisor as respondents' income and savings are correlated with their level of assets.

Respondents who are more financially literate or have a post-secondary diploma are more likely to retain the services of a financial advisor. Households that declare they will *never* save for retirement are less likely to have one. Couples with *no* children are more likely to have a financial advisor, even when we control for income and savings.

Our results are robust but rely on the assumption that advisors influence wealth rather than that wealth attracts advisors. In a survey setting, it was challenging to deal with the causality issue. Thus, our econometric approach was to use a sequential model. First we estimated the determinants of having a financial advisor. Then, we used an instrumental variable (IV) technique to control for endogeneity (i.e., a change or variable that arises from *within* a model or system) to assess how having a financial advisor affects the value of a household investment portfolio.

Question 2: What are the economic impact of having an advisor on household investment assets value?

For the second question (“What are the economic impact of having an advisor on households’ assets value?”), the econometric results show that participants using a financial advisor for more than 15 years have on average about 173% more financial assets, *ceteris paribus*, or 2.73 times the assets of “comparable” non-advised respondents. The impact of advice on financial assets (cash, GICs, term deposits, stocks, bonds, ETFs, investment funds and other investment vehicles) increases with the tenure of advice.

Question 3: How does financial advice work?

Concerning the third question (“How does financial advice work?”), the difference in financial assets is explained by higher household savings rates and a greater allocation of non-cash investments. That disciplined behaviour and greater savings habits are acquired through advice were key findings of the original paper.

The Updated Study

Power Financial Corporation commissioned Ipsos Reid to conduct a second Internet-based survey on the financial situation of Canadian households between July and August 2014.⁴ The financial and economic data assessed by the survey were for fiscal 2013.

This new survey questioned a subset of participants on the same issues as in 2010. However, one key question was added to focus on the causality issue raised before: What prompts households to seek financial advice? Respondents could select only one answer from these options:

- “Was recommended by friends/family/a trusted person”;
- “We felt the need for it”;
- “We were approached by a financial advisor”;
- “Other (please specify).”

More than 85% of advised households chose their financial advisors and were not (directly) approached by one. This statistic strongly supports our assumption in the initial study about the direction of causality from advisor to wealth.

In the 2014 survey, a subset of respondents who participated in 2010 answered similar questions. By asking two specific questions to those respondents, we add a dynamic dimension to the study which is associated with the concept of the “survival principle”:

- 1) How does the asset value of households *without* a financial advisor in 2010 *and* in 2014 compare with households *without* a financial advisor in 2010 but *with* an advisor in 2014?
- 2) How does the asset value of households *with* a financial adviser in 2010 *and* 2014 compare with the asset value of households *with* a financial advisor in 2010 but *without* one in 2014?

⁴ A total of 18,333 working-age households participated and 10,505 were retained after adjustments for out-of-scope and incomplete answers. About one-third was eligible for the study.

In Section 2, we briefly update our review of recent literature (our 2015 paper offers a complete account). In Section 3, we present our econometric analyses of these three questions:

- 1) What are the determinants of having a financial advisor?
- 2) What is the impact of a financial advisor on the value of assets?
- 3) What role do gamma factors play?

Results will be presented for both surveys; however, for households in 2014 with a financial advisor, the sample is restricted to those who declared they chose their advisor. Section 4 draws on households surveyed in 2010 *and* 2014 and discusses the survival principle.

3. The Recent Literature

Before the academic publication of our paper in 2015, a previous version had received considerable attention, notably from the investment industry. A shift in interpretive emphasis was apparent, from an advisor enhancing a portfolio through good stock picking to a more holistic view of the value of advice offered by a financial advisor. As expected, some in the industry considered the study as irrefutable proof that households should have financial advisors. While scientifically *all* studies are refutable by a better study, until proven otherwise, the results stand. In the academic literature, the main criticism of our original paper related to causality, i.e., that wealth attracts an advisor and not vice versa. Though the causality question pertains to *many other* studies, it is not always as evident as an assumption as it was with our study. Resolving this issue is the specific core consideration we address in this paper.

Many studies analyzed in our first paper dealt with the alpha factor: To what extent does an advisor increase household investment assets? Several studies stressed that the cost of a financial advisor is not justified by the low net return realized. This emphasis on alpha has *not* informed our research and does *not* apply to the current study. Our focus is on the gamma factors associated with financial advice: greater discipline, greater savings,

balanced portfolio (sometimes referred as the beta factor), etc. In our view, gamma factors increase the amount of assets *and* their value.

New papers published since our first critical review of the literature state that advisors have been unable to improve investors' risk-weighted return net of fees. However, others identified value in advice that prompted diversification and improved savings discipline, rather than in returns (see Hermansson and Song, 2016, for all the new references, including one to our 2015 paper).⁵

Two studies omitted in our earlier review raised complementary results to the current paper and deserve attention.

Kramer (2012),⁶ drew on longitudinal data of about 16,000 investors over a 52-month period to investigate if advisers add value to individual investors' portfolio decisions. He compared the portfolios of advised and self-directed (execution-only) investors⁷ and analyzed self-directed investors who switched to advice taking. His analysis confirms that advisors add positive value to portfolios.

Hung and Yoong (2010) investigated two interesting questions:

- 1) Do individuals improve their financial behaviour in response to advice?⁸
- 2) If policymakers increase the availability of unbiased financial advice, will participants seek and implement that advice?

The questions relate indirectly to the value of financial advice and both are appealing from a policy perspective. Based on a household survey, their results indicate no statistically significant consistent predictive relationship between reported use of an advisor in 2008

⁵ C. Hermansson and H. S. Song, 'Financial advisory services meetings and their impact on saving Behaviour—A difference-in-difference analysis,' *Journal of Retailing and Consumer Services*, May 2016, 30, 131–139.

⁶ Marc M. Kramer, 'Financial Advice and Individual Investor Portfolio Performance,' *Financial Management*, 2012, 41-2, 395–428.

⁷ Not exactly what we have called the 'trader' in Montmarquette–Viennot-Briot (2015).

⁸ A. A. Hung and J. K. Yoong, 'Asking for Help: Survey and Experimental Evidence on Financial Advice and Behaviour Change,' Rand labor and population, 2010, WR-714-1.

and concurrent plan-related outcomes like savings, investment, and withdrawals.⁹ In a second analysis, they turn to (hypothetical) experimental methods to better understand the causal relationship between advice and behaviour.

Respondents are randomly assigned to one of three study groups:

- 1) *Control group* – the task is presented *without* advice;
- 2) *Group two* – all respondents get the *same* advice;
- 3) *Group three* – respondents may get advice or not (“affirmative decision group”).

The authors found a large and statistically significant positive relationship between advice and behaviour *only* for the affirmative decision group. They concluded that:

- 1) Having policy makers recommend mandatory financial counseling does not remedy bad financial behaviour;
- 2) Advice recipients must be prepared to accept counsel. Accordingly, the financial literacy needed to correctly evaluate the value of financial advice is critical.

4. Revisiting the Value of Financial Advice

Some descriptive statistics

Results for 2010 and 2014 *are* discussed. However, for 2014, among advised households *only those who chose their advisor were retained*.

The data filtering was slightly different: in both cases, households needed \$1,000 in assets, an income of less than \$250,000 and a savings rate of under 90%. Retired respondents had to have government transfer income less than \$26 000 annually. The respondent was 25 years and older in 2014 and between 25 and 65 in 2010.¹⁰ Table 1, compares both surveys on the value of financial assets by categories of respondents.

⁹The survey size is 1,467 individuals with, however, few socioeconomic variables for their regression analyses.

¹⁰ The econometric results are unchanged for 2014, if we restrict the sample to those 25–65.

Table 1: Descriptive Statistics on the Value of Financial Assets by Categories of Respondents

	2010		2014	
	Advised	Non-Advised	Advised (Chosen by Household)	Non-Advised
Observations	1,785	1,825	487	1,097
Median (\$)	101,000	24,000	135,000	25,000
Mean (\$)	193,772	93,384	273,091	79,634
Standard Deviation	281,874	264,005	427,866	173,901

In 2014, 30.7% of households had an advisor (34.2% if households approached by an advisor are included); in 2010, 49%. Recent independent statistics (BC Securities Commission & Oversight, 2015) suggest the percentage of households with an advisor was oversampled in 2010.¹¹

The mean value of assets for non-advised decreased in 2014 relative to the same category in 2010. The standard deviation of the value of assets for advised households is relatively large in 2014.¹²

Figures 1 and 2 show the distribution of the value of assets respectively for 2010 and 2014 that would prompt a household to seek advice. In both cases, advised households start relationships with only modest asset levels (the median initial investment is \$11,000), while non-advised households believe they need more assets to seek advice. Among the non-advised, almost half (44%) feel they need \$50,000 plus to qualify.

In 2010, we identified another non-advised category, classified as non-advised but active (“traders”). These households self-managed their investments, identified themselves as their main source of advice, and had no advisor because they are capable of managing their own investments. Relatively speaking, they exhibit greater education, income, and

¹¹ Based on a working sample of 1,219 respondents, the study suggests that 30% of Canadians age 35 plus invest with an advisor. Note that the study does not define “advisor.” ‘National Smarter Investor Study. Public Opinion Research. Key Highlights.’ BC Securities Commission & InvestRight, 2015. 14 pages.

¹² Differences in mean value of assets between advised and non-advised households for both years are statistically significant at a 1% level of confidence by standard t-tests.

financial literacy. Nearly two-thirds of “traders” believe they need \$100,000 plus to seek advice.

In 2014, 32% of non-advised households declared that no amount of assets would make them seek advice.¹³ Via a Probit regression, we find that households with savings under \$3,000, the respondent carrying life insurance and being financially literate, are less likely to be among this group.

Thus the samples are different and limit comparisons of the results.¹⁴

¹³ This answer category was not proposed in 2010.

¹⁴ Other differences are discussed in the text.

6. Conclusions and further research

This study, based on a new Canadian survey, reconfirms the positive value of having financial advice. As in our earlier paper, the discipline imposed by a financial advisor on households' financial behaviour and increased savings of advised households are key to improving asset values of households relative to comparable households *without* an advisor.

Two major research elements were associated with the new survey.

First, a new question was added to the previous questionnaire to identify who approaches whom for financial advice. This has been referred to in the literature as the causality issue: Does financial advice *improve* household wealth, or is it household wealth that *attracts* advice? Through our improved questionnaire, we found that more than 85% of households

with a financial advisor chose their advisor and were not approached by one. This important statistic validates to a large degree our assumption on the direction of causality from advisor to wealth as in our previous study. It provides an easy way to disentangle the causality issue by restricting our analysis to households declaring they found their advisor.

Second, we were able to compare the financial situation of 282 households in 2010 and 2014 and to evaluate the consequences of having or not having a financial advisor in the evolution of their assets value.

As expected, for both surveys, key factors that positively affect the probability of having a financial advisor are: income, savings capacity, age, education level and financial literacy.

The two regressions investigating links between asset levels and household use of an advisor confirm the active role of financial advice on asset values. However, some differences associated with the importance of this advisory effect became evident.

In 2010, having a financial advisor for at least four years affected financial asset levels of respondents. Compared to non-advised households, the long-tenured (15 years plus) advised households had 2.73 times more financial assets. With the 2014 survey, the presence of a financial advisor proves its effect as soon as the first four years. The additional value reaches 290% for a household with an advisor for 15 years or more: 3.9 times the value of assets of the equivalent non-advised households.

For both surveys, the discipline associated with a long-tenured financial advisor and greater savings are key to explaining the differential in household asset values over those without an advisor. The effect on savings from advice is greater in 2014 than in 2010.

Applying the survival principal, it is evident from our panel data that dropping an advisor between 2010 and 2014 was costly: those households lost a significant percentage of their asset values while the households who kept their advisor have gained in asset values.

In short, financial advice matters, and the results are robust.

But, more has to be done to better assess the value of financial advice. One area of research is on the role of financial literacy. Sometimes, presented as a substitute to a financial

advisor by regulators, this study put forward the complementary dimension between financial advice and financial literacy. Other topics of interest: Do low balance or low-income investors benefit from having advice? A more comprehensive definition of 'Asset mix', and its impact on performance, as an additional determinant of the value of advice. Why do investors drop their advisors? How much one is willing to pay for advice if it has a value?