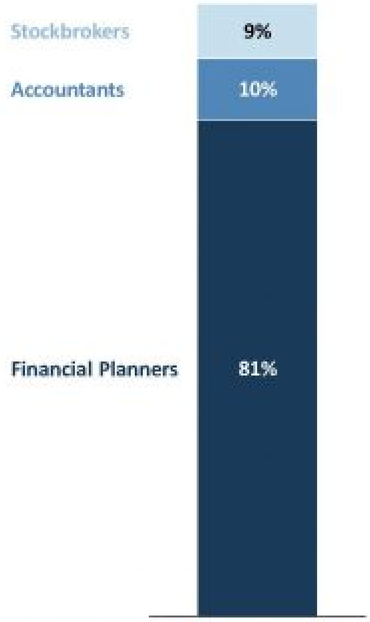
The forgotten advice distribution opportunity

January 24, 2019

There is no doubt that there are significant shifts occurring in the advice industry: FASEA will see many advisers leave the industry (though mostly the non-productive ones), the shift in licensing model to 'independent' continues unabated and the overlap between accounting and financial advice continues to grow.



Amongst all this change, many asset managers are also considering how to engage with the almost three thousand accountants to be found on the financial adviser register.

While the sheer number of accountants might make them look like an attractive segment, we think it's probably fool's gold. There may be a handful of accountants who will provide investment advice on a regular basis (and therefore present a potential distribution opportunity), however, there is a different type of adviser altogether who represents lower hanging fruit for managers and platforms to consider.

Stockbrokers have been reviewing their customer proposition and advice model for some years, and are now well advanced in adopting broader portfolios, with over a third of stockbrokers' portfolios following some centrally created and well-diversified model.

Interestingly, the last few weeks have also seen several transactions in this part of the industry (Ord Minnett, Patersons, and DJ Carmichael have all gone through ownership changes) as buyers and sellers take a different view on the ability to create value for clients in a stockbroking model. Irrespective of who is right, it is clear there is significant shift occurring in the stockbroking component of the advice channel.

As we see it, there are three shifts that make stockbroking an interesting distribution opportunity for product providers:

•**Stockbrokers have always needed to move beyond Australian equities and hybrids to compete with traditional financial advisers.** The breadth of listed product now available via the ASX (ETFs, LICs, LITs, bonds, etc) gives stockbrokers much better opportunities to create fully diversified portfolios, and without having to look beyond the ASX. This creates a largely new distribution market for asset managers (at least those with the right product structures).

•**Brokers have historically used internal administration platforms (charged at a high cost point) to provide administration and reporting to clients.** The increasingly competitive platform market will challenge stockbrokers to charge in a fashion similar to traditional financial advisers, and separate their advice and administration fees, particularly as brokers come to terms with the best interest duty.

•**Brokers will be substantially impacted by upcoming advice changes –** they are much less likely to meet the FASEA qualifications, and have (on average) a longer tenure than the average financial planner, which means they need to broaden their retail advice offer beyond direct equities into diversified portfolios and strategic advice to offset lost revenue.

However, as always, these things need a good catalyst for change to occur. While brokers have been thinking about the revenue model for some time given falling trading revenue, we believe the current regulatory environment will place a limit and/or timeframe on placement fees (which currently remain exempt under FOFA), forcing brokers to reconsider their proposition (not just from a revenue perspective, but also putting the client first).

Providers (asset managers, platforms and insurers) who start broadening their distribution into stockbrokers now are likely to be better placed for the opportunity presented by the slow and steady shift of stockbrokers into broader strategic advice.

By [Andrew Baker]

By [Evan Baars]

[4 realistic ideas about pensions disengagement]

January 24, 2019

Member disengagement in workplace pensions is well documented; with similar issues evident in individual pensions, providers need to be smart but realistic in their communications strategy.

By [Andrew Baker]

By [Evan Baars]

[Sizing the DB transfer market]

January 24, 2019

The DB transfer market has been a key new source of retail flows in recent years but is under considerable regulatory pressure. Although run rates are well off their peak, underlying dynamics mean that DB transfers should continue to play an important role in new flows.

By Andrew Baker  **By Evan Baars**

UK wealth value chain is gradually contracting

January 24, 2019

The UK wealth industry value chain has been resilient over the past decade, despite many changes including rapid growth in AUM, the rise of platforms as a dominant method of distribution to consumers, and access to wholesale or institutional pricing from asset managers.

By Andrew Baker  **By Evan Baars**

The advice gap is dramatically overstated

January 24, 2019

There have been many 'Chicken Little-esque' predictions that the sky is falling in, that FASEA and the fall-out from the Royal Commission will decimate the number of advisers in the industry, creating a large advice gap and preventing many investors who could benefit from advice from being served.

By [Andrew Baker]

By [Evan Baars]

[3 reasons why passive share may top out]

January 24, 2019

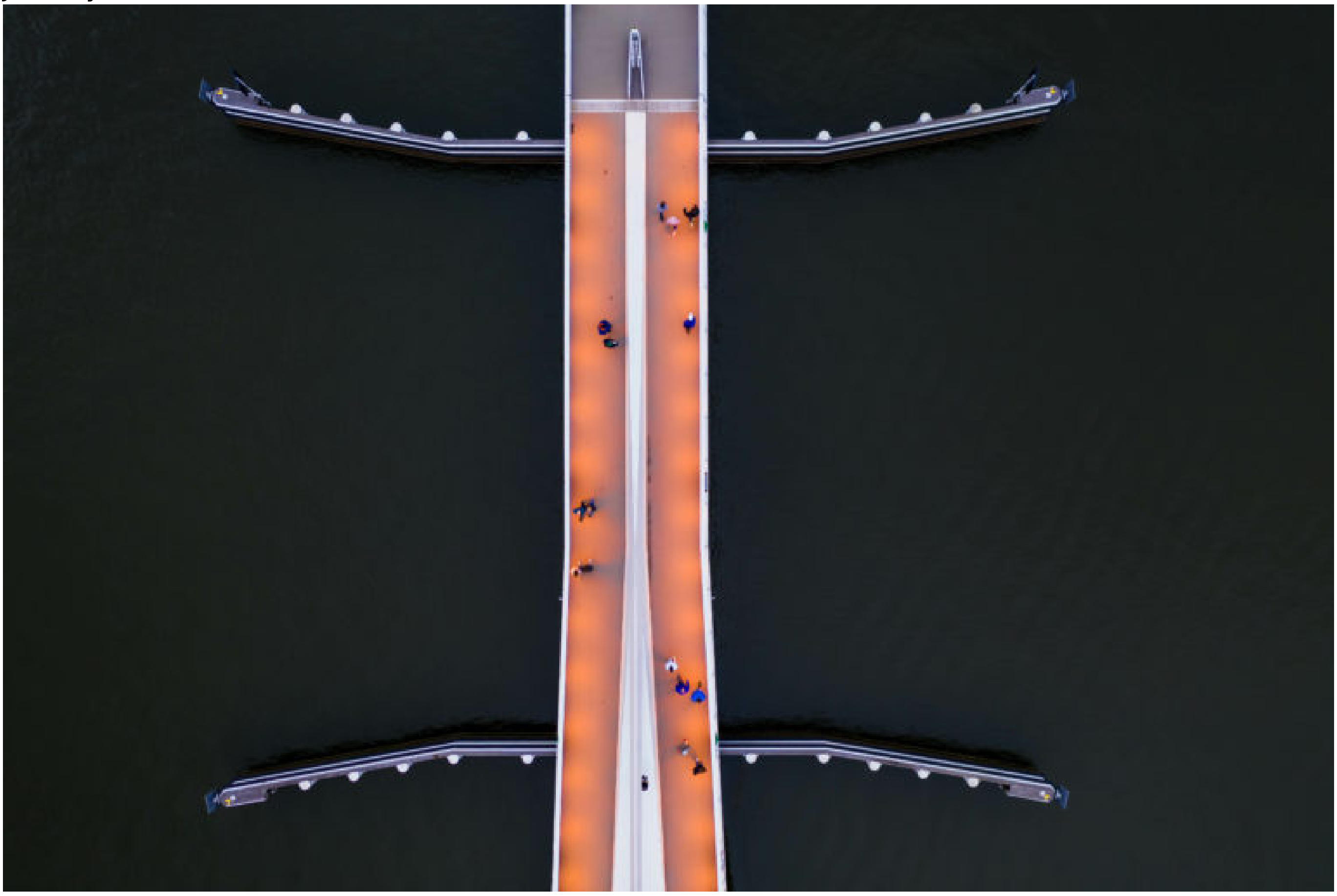
The upwards march of passive market share seems unstoppable. But there are reasons to think why, in some institutional segments at least, market-cap passive share may peak soon.

By [Andrew Baker](#)

By [Evan Baars](#)

[Reinsurance Broking: Is two too few?](#)

January 24, 2019



Is two too few?

M&A strategies in the primary P&C broking segment often have unintended ramifications upstream. And, on occasion, industry segments can become over-consolidated. In the case of reinsurance broking, two global giants would likely be too few, potentially pushing insurers to seek out new reinsurance broking partnerships in response. Maybe.

Save the biggest 'til last?

‘Aon Willis’ was a possibility for all of 24 hours only to be shelved for a minimum of twelve months. As it is common practice to do regular and comprehensive reviews of key competitors and was a forced disclosure, perhaps no further contemplation is merited. It did offer food for thought, however.

The recoil from the initial announcement indicated this was both unexpected and shock-inducing in terms of what it might have meant for the competitive landscape and jobs in broking generally.“The reinsurance broking industry is at the same time both consolidated and fragmented”

Such transactions are necessarily premised around primary (as opposed to reinsurance) broking businesses. Broking models are vertically-integrated, underpinned by significant operational synergies, meaning primary market motivations usually have significant knock-on effects in reinsurance broking.

A trawl through our global database reveals that there are well over 100 reinsurance broking firms globally, although just four have genuinely global franchises. The reinsurance broking industry is thus at the same time both consolidated and fragmented.

Post final approvals, Guy Carpenter’s absorption of JLT Re will serve to create two broadly equal-sized global giants in reinsurance broking, with the next competitor (Willis Re) being about half their size. Were Aon to acquire Willis Towers Watson the number of genuinely global reinsurance brokers would reduce to just two. What might be the ramifications for the reinsurance broking segment, and for the value chain in general?

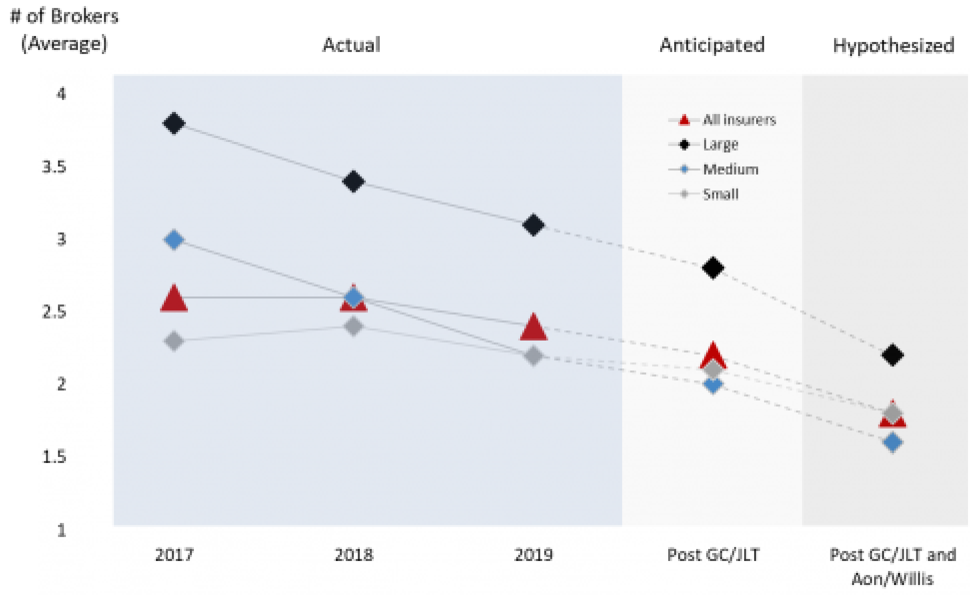
While insurer consolidation and decision centralisation are key challenges for reinsurance brokers, there are also growing revenue pressures (rebates and/or fees). Reinsurance brokers also receive regular signals for investment in terms of new capabilities, particularly data modelling and keeping pace with new technologies, propositions and business models.These support the case for scale advantage and hold relevance for a consolidation thematic.“Under the Aon Willis scenario, the two largest brokers combined would likely account for up to two-thirds of the reinsurance broking industry”

On a ‘steady state’ basis: Aon Benfield + Willis Re could expect to be 50% larger than Guy Carpenter + JLT Re, a scale differential that would be unlikely in itself to cause concern at an industry level.

These two largest reinsurance brokers combined would then however likely account for up to two-thirds of the reinsurance broking industry (by revenue and by number of active brokers). In the absence of any meaningful shrinkage, ‘Aon Willis Re’ would potentially be 15 times the size of the third-ranked competitor.

How well would the resulting industry structure post Aon Willis fit with insurer requirements?

Exhibit 1: Reinsurance Broker Usage



Source: NMG's Global P&C (Re)insurance Programme (2017-19, Forecast)

On average, 'Large' insurers today make use of three reinsurance brokers (down from nearer four two years ago), in so doing benefiting from a diversity of expertise, analytical models, and a multitude of pathways to test market appetite and pricing via different networks. 'Medium' and 'Small' insurers currently make do with just over two.

Insurers seldom indicate plans to trim the number of brokers used, yet there is quantitative evidence for rationalisation of broker usage, driven by both demand and supply factors.The effects of Aon Willis would be most pronounced among large insurers: two-thirds use three or more brokers, of which nearly 90% use all of the big three.

At-scale brokers have broadened their offerings, narrowing the 'slots' available for the differentiated propositions of others to fill. So far, it would seem, insurers have found this sufficiently compelling. Consolidations – pending and hypothesized – would however have a considerably greater effect.

Guy Carpenter + JLT Re is unlikely to impinge significantly on insurer choice, reflective of the relatively smaller client footprint of JLT Re. Willis Re has twice the client footprint of JLT Re however, which would translate to a fall in average usage to just two brokers under Aon Willis. The effects would be most pronounced among large insurers: two-thirds use three or more brokers, of which nearly 90% use all of the big three. It would seem reasonable that Large insurers could most feasibly look to build new relationships, thereby capping the scale and efficiency benefits available (even assuming some of these efficiencies would be shared with clients).

Many of the leading value drivers for broker selection, including personal relationships, domain expertise, and service quality can be achieved in the absence of scale. 'Boutique' brokers may well be successful operating on a business-as-usual basis despite large-scale consolidations taking place, possibly even experiencing favourable tailwinds by way of increased vibrancy in their segment. This could be particularly relevant for larger boutiques, where an aggregation play might now hold more appeal (ie to become the distinct third-ranked reinsurance broker).

The bear scenario for boutiques lies in the idea that consolidation activity will move broker engagement models from a setting of preference to one of need, with buyer behaviours shifting permanently towards few reinsurance broker partners as a result.

Mostly likely, contemplating the full range of scenarios, reinsurance broking will remain a highly dynamic segment.

By [Andrew Baker]()  **By [Evan Baars]()**

[AustralianSuper builds $70m war chest]()

January 24, 2019

The last few years have seen AustralianSuper dominate the pensions landscape in Australia, topping the charts in terms of net flows year after year.

By [Andrew Baker]()  **By [Evan Baars]()**

[Advice fees but no service: a question of criminal law]()

January 24, 2019

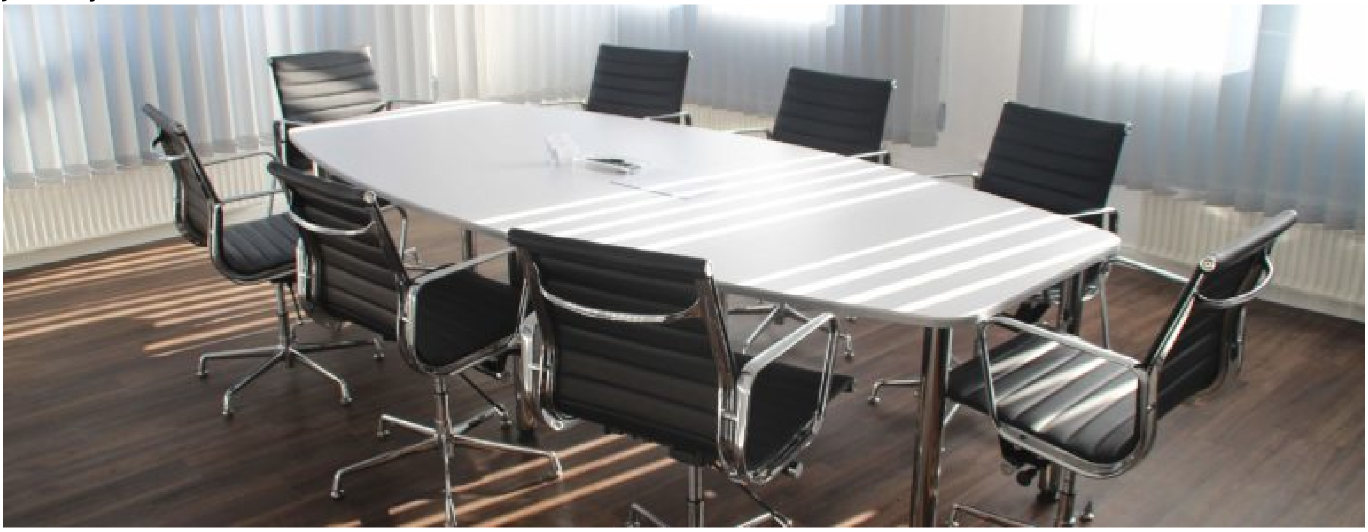
The threat to vertical integration has receded but financial advice is under attack. Ongoing fees underwrite the economics of advice, but if services are not delivered, a crime may have been committed.

By Andrew Baker

By Evan Baars

Adviser remuneration reforms

January 24, 2019



By investigating practices implicit in vertically integrated business models, the Australian Royal Commission report is likely to ask serious questions of the wealth management industry: UK wealth managers need to take note.

In early February a seminal report into misconduct in the wealth management industry is expected to be released which is likely to have profound consequences.

Since December 2017, an Australian Royal Commission has been investigating the banking, superannuation (pension scheme), and financial services industry, seeking out misconduct, conduct falling below community standards, and misuse of retirement savings. As the name suggests the remit has been broad, but some of the biggest impacts have been in the wealth industry, particularly relating to financial advice.

Even before the publication of the interim report last September, the Commission's hearings had cut a swathe through the Australian wealth industry. It has already **ended careers** of numbers of senior executives, CEO, and board members, raised the possibility of **criminal charges** being laid, and contributed to the **destruction of conservatively £5 billion in market value**.

Australia may be an island – albeit a big one – but it's a globally significant pensions market. It is often looked to for lessons learned – good and bad – by market participants and regulators elsewhere. For UK market participants, where vertical integration (VI) has returned to the wealth industry in a range of models, there are some important warning signs to consider before the FCA does.

Key questions for UK

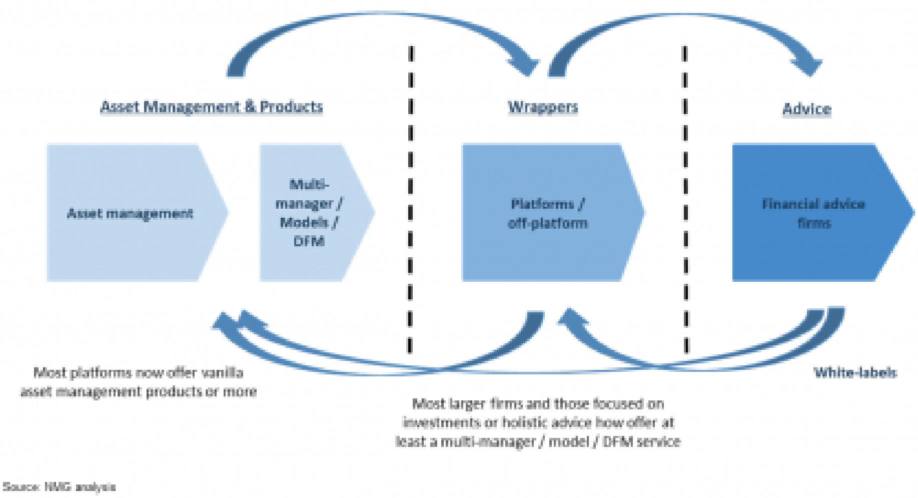
The final report will no doubt be lengthy, complex, and wide-ranging. However we see two critical questions emerging which are just as relevant for the UK wealth industry:

- **How do you prevent financial incentives from corrupting the advice given to consumers?**
- **Given that VI facilitates this outcome, do you need to structurally separate advice from product manufacture and sales?**

VI has been increasingly prominent in the UK over the last few years, in two distinct guises: (Figure 1):

- **Forward integration**: product owners (particularly of platforms) moving to acquire financial advice providers.
- **Backward integration**: financial advice providers moving to develop or white label investment products and / or platforms; and platforms developing in-house investment products (particularly multi-manager, model portfolio providers, and DFM type products).

Figure 1: UK vertical integration trends



Pros and cons of vertical integration

VI is not fundamentally a bad thing for consumers. Wealth products and services are complex and many consumers experience information asymmetries. **VI can allow a market participant to offer more complete services and a better experience via a "walled garden" of quality-vetted solutions**. In an industry value chain where certain activities are highly valued or under-valued by customers relatively to their cost of delivery, **VI can also be a relatively efficient way of reallocating value more evenly across activities**.

Given that consumers often are not prepared to pay much for advice, platforms generally experience low margins, but asset management enjoys high margins, **there are also strong financial incentives for different market participants to vertically integrate**. Advice and platform owners have an incentive to move into asset management, and asset managers and platform owners have an incentive to offer advice providers a slice of the margin action.

That's at the heart of the trouble. How do you protect consumer / client interests when advice providers have direct or indirect access to product economics in the form of access to bps revenues or salary bonuses linked to sales volumes?

There's a high risk that the Commissioner will conclude that it can't be done – **that the conflicts of interest inherent in these arrangements cannot be managed and that governance frameworks do not actually work in practice**. The interim report posed a set of key questions:

- **Why do individuals dealing with customers (and their superiors) need to be rewarded with incentive payments (such as bonuses beyond salaries or product economics beyond professional fees) to do their job properly?**
- **Given that such incentive payments typically come from selling the client a particular product, how do you protect the client – especially when no change to existing arrangements is often the right answer for the client but not for the employee / adviser?**
- **Given that interests too often trump duty, how do you reconcile VI with the duty to the client? Should product manufacturers and their associates be prevented from providing financial advice to consumer in relation to the type of product(s) they manufacture?**

Those questions have been on the table since last April and have not gone away. If anything the accumulation of evidence has magnified them.

Routes to non-conflicted models

While it might take some time for implications to become apparent in the UK, vertical integrators should get ahead of the curve – starting with answers to the above questions. NMG has assessed some practical routes to non-conflicted models, including **advice KPIs based on NPS and other customer measures**, **charging for advice on a standalone cost plus margin basis**, and demonstrating an **equitable sharing of VI value – not just benefits – with customers**.

VI creates the scope for more conflicts of interest, but a non-vertically integrated industry structure doesn't necessarily result in better outcomes for the client. The right VI model can put the UK wealth participants on a more sustainable financial footing – and better placed to deliver for the customer – so long as they remember whose interests come first and avoid the excesses of the Australian industry, which have finally come home to roost.

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