2.08%	0.42%	1%
Average management expense ratio (MER) for long-term mutual funds	Average MER for exchange-traded funds in Canada	Average commission and tax embedded in the MER of most equity mutual funds

NO SAVING GRACE

FUND FEES UNDER THE MICROSCOPE

Canada lags in making fee-based accounts the investing norm

By David Pett

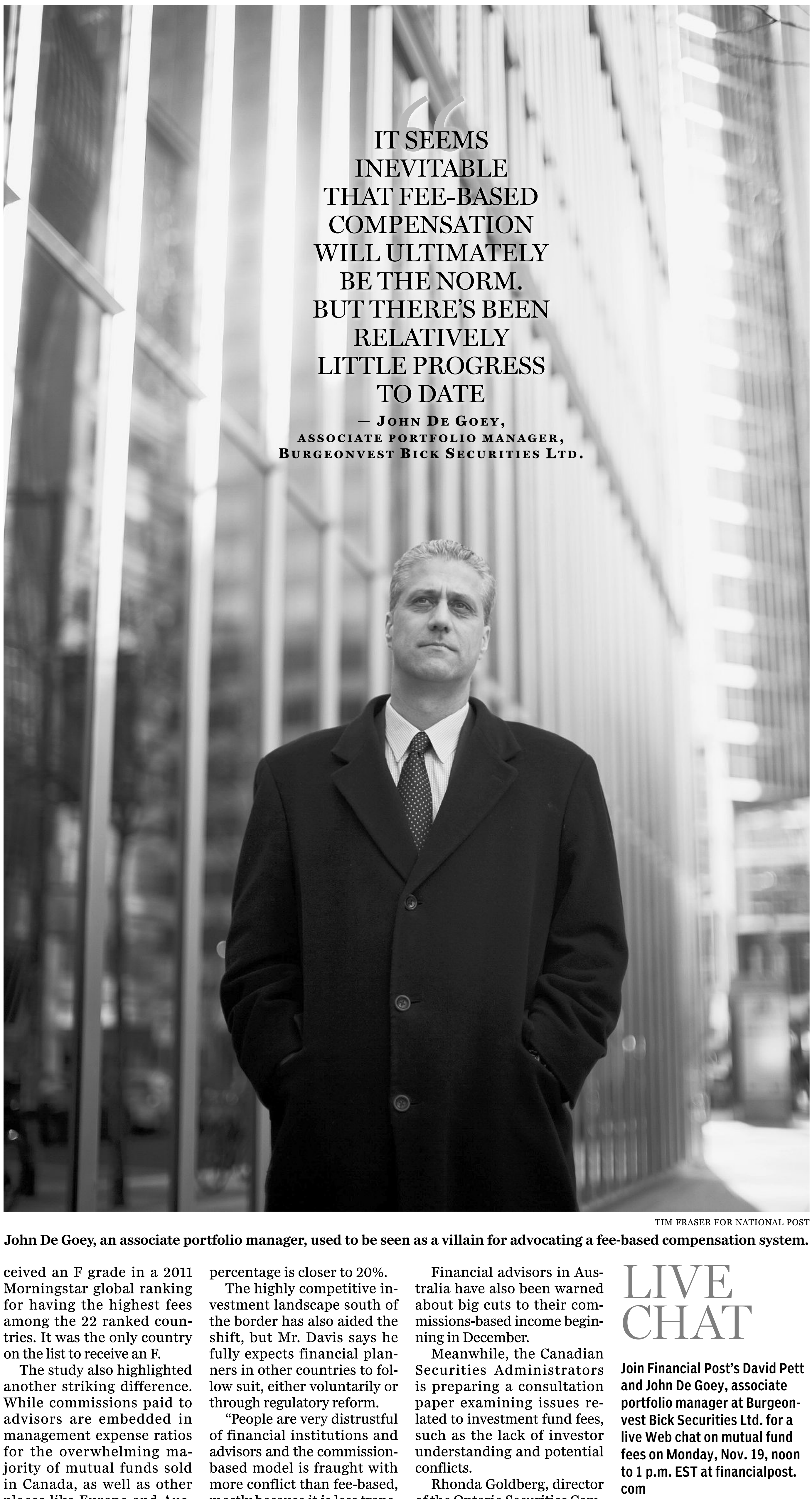
John De Goey was considered a villain when he started arguing in the early 2000s that fee-based compensation was the necessary way of the future for Canada's investment industry. The idea that financial advisors would have clients pay directly and transparently for their services was a slap in the face to the commission-based model that had long been their bread and butter.

Today, the majority of Canadian advisors earn their living from "trailer fees" embedded in mutual funds so quietly that many investors believe the advice is free. Some people buy mutual funds without an advisor, in which case the fees are still charged.

However, a growing number of advisors have shifted their structure to charge a flat percentage of the amount invested — generally 1% more or less depending on the portfolio size and allocation. Some advisors choose to provide advice only, for a flat fee, leaving the perhaps more sophisticated investor to execute the transactions themselves.

"I'm no longer a villain because the concept is now mainstream," says Mr. De Goey, associate portfolio manager at Burgeonvest Bick Securities Ltd. in Toronto.

Still, many in the profession remain reluctant to make the shift in how to earn their keep, leaving the pace of change stubbornly slow. Without more decisive action from Canadian regulators, Canada is in danger of falling further out of sync with the rest of the developed world.



IT SEEMS INEVITABLE THAT FEE-BASED COMPENSATION WILL ULTIMATELY BE THE NORM. BUT THERE'S BEEN RELATIVELY LITTLE PROGRESS TO DATE

— John De Goey, associate portfolio manager, Burgeonvest Bick Securities Ltd.

TIM FRASER FOR NATIONAL POST

John De Goey, an associate portfolio manager, used to be seen as a villain for advocating a fee-based compensation system.

"It seems inevitable that fee-based compensation will ultimately be the norm," Mr. De Goey adds. "But there's been relatively little progress to date, and I think it'll be a while before asset-based fees become the dominant paradigm."

The debate pitting upfront fees against commissions or trailers has heated up in the low-return environment that has defined equity investing for much of this century.

"It's easier to ignore when you are in a strong market environment," says Christopher Davis, director of fund analysis at Morningstar Research Inc. in Toronto.

"Investors in the '90s didn't care. When you're making 15% or 20% on your investments, who does? But for more than a decade, global stock markets have kind of gone nowhere."

Mr. Davis said Canada's fund industry is at the "back of the pack" when it comes to fees and expenses being charged to investors and received an F grade in a 2011 Morningstar global ranking for having the highest fees among the 22 ranked countries. It was the only country on the list to receive an F.

The study also highlighted another striking difference. While commissions paid to advisors are embedded in management expense ratios for the overwhelming majority of mutual funds sold in Canada, as well as other places like Europe and Australia, the practice is not nearly as prevalent in the United States.

Even when trailers are included in the management expense equation south of the border, they tend to be smaller. The United States seems to be leading the way in turning to fee-based models. Approximately 55% of advisors are now fee-based in the U.S., say studies conducted by Vanguard Group Inc., while in Canada, the percentage is closer to 20%.

The highly competitive investment landscape south of the border has also aided the shift, but Mr. Davis says he fully expects financial planners in other countries to follow suit, either voluntarily or through regulatory reform.

"People are very distrustful of financial institutions and advisors and the commission-based model is fraught with more conflict than fee-based, mostly because it is less transparent."

Regulators in the U.K. have already announced a ban on commission-based mutual fund sales that will come into effect Jan. 1. Britain's Financial Services Authority said a more transparent fee-based model that emulates other professions such as law, will help ensure investors are offered products matching their needs rather than those that pays the salesman the best commission.

Financial advisors in Australia have also been warned about big cuts to their commissions-based income beginning in December.

Meanwhile, the Canadian Securities Administrators is preparing a consultation paper examining issues related to investment fund fees, such as the lack of investor understanding and potential conflicts.

Rhonda Goldberg, director of the Ontario Securities Commission's investment funds branch, said their paper is to be out before the end of this year. It isn't expected to make strong recommendations, but will instead kick off more discussions in the new year.

Some critics worry that private investors will balk at paying an upfront fee and that consumers will shun advice altogether — and possibly make inappropriate investments on their own — once they clearly see the costs laid out.

LIVE CHAT

Join Financial Post's David Pett and John De Goey, associate portfolio manager at Burgeonvest Bick Securities Ltd. for a live Web chat on mutual fund fees on Monday, Nov. 19, noon to 1 p.m. EST at financialpost.com

This may be true, particularly among consumers who mistakenly believe the advice they are getting is free, but Mr. De Goey thinks it's important to bring a higher level of professionalism to the industry.

One of his major concerns is the practice of embedded compensation that forces consumers to pay for advice whether they use it or not. He points to the fact that discount brokerages in the country mostly sell mutual funds that include embedded commission or trailers even though they don't provide advice to clients.

CANADA GETS A FAILING GRADE

GRADES FOR TOTAL EXPENSE RATIOS FOR FINANCIAL PRODUCTS

Australia	A
Thailand	A
U.S.	A
Switzerland	B+
Germany	B
South Africa	B
China	B-
Japan	B-
Netherlands	B-
New Zealand	B-
Norway	B-
Sweden	B-
Belgium	C+
India	C+
France	C
Singapore	C
Taiwan	C
U.K.	C
Hong Kong	C-
Spain	C-
Italy	D+
Canada	**F-**

SOURCE: MORNINGSTAR
ANDREW BARR / NATIONAL POST

"The system obviously needs to change," he says in his latest book, *The Professional Financial Advisor III*. "The most obvious solution is to abolish embedded compensation products altogether."

Some advisors fear for their financial well-being, Mr. De Goey says. Others might have technical issues in making the transition, particularly those registered to sell products through the Mutual Funds Dealers Association (MFDA).

While one-third of all types of advisors offer fee-based services to at least some of their clients, just 14% of MFDA advisors do so compared to 70% of advisors who are licensed by the Investment Industry Regulatory Organization of Canada (IIROC), an Environics study says. Furthermore, as a proportion of their total compensation, fee-based income represents on average only 5% of an MFDA-licensed advisor's income, the same as it was back in 2003. But 33% of an IIROC-licensed advisor's income is derived from fees, up from 20% in 2003.

MFDA advisors are more limited in the types of securities they can sell when compared to IIROC advisors who are able to sell individual stocks and exchange-traded funds, both of which are more compatible to fee-based compensation models.

Ultimately, there may be no quick fixes when it comes to the ongoing debate between fees and commissions, but the fact that high-level discussions within the industry are taking place on the matter is encouraging, said Atul Tiwari, managing director at Vanguard Investments Canada.

"To our way of thinking, it is a great way to start the discussion in a broader way," he said. "Hopefully, it will raise awareness and help investors understand what they are paying for their investments and making a decision around whether they are getting fair value."

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