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The Gathering Storm: Challenges for Mutual Fund Dealers and their Representatives

"If you don't like change, you're going to like irrelevance even less"

General Eric Shinseki, Chief of Staff US Army

Mutual Fund Dealers and their Representatives, the recent market turmoil may feel like the latest tsunami to have battered their industry. However, what truly ails the Mutual Fund Dealer community is much deeper and more structural than stock market declines.

This article is the first in a series of three articles that will discuss current challenges and solutions for the Mutual Fund Dealer industry. In this paper, we will review some of the common issues faced by Mutual Fund Dealers and Representatives in the existing business environment.

The Iron Age

Mutual fund representatives who started their career decades ago may view the 80s and 90s as a golden age. As baby boomers progressed to their high income high earning years, and the public began a love affair with investing and the public markets, the pool of retail assets under administration grew rapidly. There were ample opportunities for all market participants, including, Investment Dealers, Mutual Fund Dealers and Investment Counsel/Portfolio Managers.

If the 1980s and 1990s were the golden age, the 2000s can be described as the iron age. Prior to the impact of recent market turmoil, the pool of retail assets under administration had stopped growing due to maturation of that market. More significantly, higher end retail investors were becoming more sophisticated, requiring a wider offering of products and services.

Recent market volatility has simply accelerated the contraction of the retail pool. It has also caused many higher end retail investors to more carefully scrutinize the quality and value offered by their financial advisors.

A declining pool of investable funds and higher client expectations has translated into greater competition between financial providers. In a contracting market, the participants that survive are those who can pro-actively address their areas of competitive weakness.

Documentation of Client Order Approval

According to Natural Resources Canada, a household can save up to 9000 liters of water per year by simply fixing a leaky tap.

Not only is this a wonderful water saving tip, but it also highlights an important point, which is that small inefficiencies can, over time, have a significant impact.

A small inefficiency that appears to be slowly devouring many Mutual Fund Dealer Representatives is the requirement to obtain a client signature for each order.   This administrative burden becomes even more onerous for representatives that apply model portfolios for the management of client accounts. Any change to the model portfolio requires the Representative and his or her staff to spend considerable time contacting a large number of clients and organizing the paperwork across a large number of accounts.

The need to obtain client signatures can be alleviated by obtaining a "Limited Trading Authorization" from clients. However this is an incomplete solution. Registered staff must still contact clients personally and ensure all client approvals are documented in good form.

The Mutual Fund Dealers Association ("MFDA") often spends a considerable amount of time and effort during their firm visits, verifying whether Representatives have properly documented client approval.   If such approvals not been adequately documented, the Dealer and/or Representative may find themselves charged with "unauthorized discretionary trading".

The most obvious cost arising from the requirement to obtain client approval for each order is administrative burden, paperwork and staff time. Excessive administration can also create an environment where client and account errors breed more easily.

However, the most significant cost of this requirement is that it robs Representatives of a critical resource 33- time and focus to grow their business.

Prohibition Against Commenting on Equities

Mutual Fund Dealers and their Representatives also have a significant disadvantage because their mutual fund dealer registration restricts them to offering only one category of investment - mutual funds.

Many Mutual Fund Dealers in Ontario also hold a Limited Market Dealer license, which allows them to sell other types of securities to Accredited Investors. However, as explained in the "Regulatory Burden" section below, the regulatory environment has forced many Mutual Fund Dealers and their Representatives to restrict their offering of new and different products.

The inability to offer, or even comment on equities can lead to the migration of high-end clients to other types of financial service providers. Clients may also believe that their Mutual Fund Representative are not very sophisticated on investment matters if they cannot offer products other than mutual funds.

Regulatory Burden

The Mutual Fund Dealer community is also under pressure from the aggressive and restrictive regulation of their industry. Securities Market Participants are regulated in two ways. The securities regulator establishes minimum requirements to become registered, then the Self Regulatory Organization sets out the club rules (i.e. the rules and regulations) for these participants.

The admission requirement for Mutual Fund Dealer Representatives are presently very low. At a minimum, an applicant simply has to complete a three hour exam, the Canadian Investment Funds Course, and have some form of industry experience before they can call themselves a Mutual Fund Salesperson.

Hence, the MFDA compensates for this weakness by tightening the club rules and enforcing them more aggressively.

For example, consider the MFDA requirement that all members must undertake a due diligence on all products they sell to clients. Few industry professionals would disagree with the intent of the rule, which is to ensure Representatives know what they are selling, and clearly understand the risks of certain products before they put their clients into such product investments.

The difficulty, however, is the regulator's application and enforcement of this requirement. For example, many firms have been advised that the MFDA considers Principal Protected Notes (PPNs) to be high risk. However, the risk of any structured product such as a PPN is partly a function of how the product is structured. A PPN is not necessarily high risk if properly structured.

Many Mutual Fund Dealers and their Representatives have simply abandoned offering new and innovative products and have further ceded their competitive position to Investment Dealer and Investment Counsel/Portfolio Manager competitors, because of a strict enforcement of the due diligence rule.

For seasoned Mutual Fund Dealers and their Representatives, a restrictive regulatory regime places them at a significant competitive disadvantage.

Business Valuation

In May 2004, Investors Group Inc. announced that it had acquired all the outstanding common shares of IPC Financial Network Inc. ("IPC") for consideration of a little less than $100 million. At the time of purchase, IPC had approximately $7.3 billion assets under administration and $1.3 billion assets under management. It also reported a pre-tax loss of approximately $12 million for its prior fiscal year. Upon completion of the transaction, Investors Group Inc. announced that IPC would continue to operate independently. In other words, Investor Group Inc. paid good money, for assets under administration, not profits.

The IPC transaction illustrates that the value assigned to a retail distribution reflects their use as a pipeline for the distribution of financial products. The profitability is often a secondary issue. The value of a distributer is effectively based on the demand and supply for distribution, and not on profits.

For example, in the current environment, a Representative can expect approximately 2 to 3 times trailers for his or her assets under administration. However, ten years from today, as baby boomer Representatives approach retirement, the volume of retail books of business available for sale may increase, and the price that Representatives can get for their books of business should fall as a result...just in time for retirement.

The IPC transaction further suggests that significant profits are earned through the design and manufacture of products, not their distribution. Mutual fund dealers and Representatives that do not manufacture the products they sell are effectively "leaving significant amounts of money and business valuation on the table" for third party firms.

Mutual Fund Dealers and their Representatives need a strategy to enhance the value and profitability of their operations, to offset revenue lost through recent market turmoil.

Conclusion

We believe that as the Mutual Fund Dealer industry approaches the end of its natural business cycle, Mutual Fund Dealers and their Representatives will be subject to increasing competitive pressure in a shrinking retail market.

These industry participants need strategies to address the competitive disadvantages arising form greater administrative burden, regulatory burden and restriction on product and service offerings.

In light of recent declines in sales and profitability, Mutual Fund Dealers and their Representatives also need strategies to reclaim some of the value they have been generating and simply relinquishing to others.

The next article will discuss low cost and effective strategies to address each of these concerns. If you would like to obtain a copy, please e-mail your request to info@aracomplaince.com.