Managing Conflicts of Interest

Few, if any, relationships can exist without some degree of conflict of interest and the depth and character of the relationship hinges on how these conflicts are managed. In personal relationships this is commonly known as 'give and take' and it is our willingness, on occasions, to put another person's interests before our own which builds the essential trust on which most relationships are founded. Indeed conflict management lies at the heart of relationships and without any conflict, it is hard to envisage how a meaningful relationship could actually develop.

Much the same applies in business and nowhere more so than among suppliers of financial services. Institutions may not exactly wish the customer to love them, but they do wish to be trusted, both as individuals and as organisations. It is the need to build long term trust which is their incentive to manage conflict effectively, in the knowledge that their reputation or brand depends upon it. Any hint that a customers' trust is being abused can seriously damage the brand.

Theoretically, there should be no more cause for regulation of conflict in financial services than in other areas of business, apart from the obvious need to protect the innocent and the vulnerable from 'conmen' and fraudsters. Indeed those who believe that practically all conflict can - and should - be eliminated by regulation are themselves undermining the interests of the consumer, by imposing excessive cost burdens upon the industry, which are reflected in higher prices and restrict the availability of the very advice which those customers so desperately need.

On the other hand, the regulators have a point and those who are trying to resist the tide of regulation can hardly deny the following compelling evidence:

1. The explosion in financial services has brought serious abuses, which have severely undermined consumer trust in financial institutions and advisers.
2. There have been numerous unacceptable scandals, many perpetrated by large and respected institutions on a massive scale including, for instance, the mis-selling of pensions in the UK, where millions of victims are currently seeking compensation totalling about £11 billion.
3. Market research suggests that many affluent consumers have given up the search for competent, impartial advice, because they despair of finding it.
4. The economic viability of personal financial services is underpinned by a deeply entrenched culture of hidden charges, without which many providers would be wiped out.

Some institutions, under pressure from the regulators, have recognised that fundamental changes are required in the commission based, product sales culture of their salesforces, but few have yet produced a convincing alternative.

The fact that abuse can have arisen so openly and on such a huge scale, even in a highly regulated environment such as the UK, suggests that regulation may not be the whole answer and that improvements in the quality of financial advice will only develop in response to consumer pressure, as the customers become better informed and more discriminating. Intermediaries have a key role to play in this and should satisfy themselves, in introducing clients to financial advisers, that the key areas of potential conflict are fully understood.

The first and most obvious area to be understood and compared against alternatives is the total amount of charges paid by the client, including all fees, commissions and all the 'hidden' charges contained within packaged products, such as mutual funds or insurance bonds. The strong incentive for suppliers to hide as much as they can get away with apparently conflicts with the desire of the client to know precisely how much he or she is paying.

It is, however, not quite so straightforward as it sounds and we have ample evidence that, for all the talk of transparency,

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many consumers, in practice, actually prefer a significant element of hidden charges, because they would not be comfortable in being confronted with the size of the total bill, any more than they want to know how much profit is made by the car salesman or the supermarket. There are complex issues of psychology here, the point being that the conflict is not just between the supplier and the client, but within the client him or herself - the age old conflict of wanting something for nothing! This is one of the principal reasons that suppliers continue to get away with practices which should logically have been eliminated many years ago.

In general, total charges for investment management range from around 0.5 percent to 2.5 percent per annum (sometimes plus 'front end fees'). Discerning clients and intermediaries will wish to evaluate the additional benefits on offer from paying say 2 percent (which may equate to the entire post tax dividend income on an equity portfolio) as opposed to 0.5 percent - and will not be taken in by claims of superior performance which cannot be substantiated. There is indeed another conflict here, in that most investment managers like to leave the client with the impression that they can outperform the market, over an extended period, contrary to all the evidence that such claims are almost impossible to justify.

On the other hand it clearly is in the interests of clients to be satisfied that the supplier receives adequate remuneration for what he does, because he is otherwise likely to cut corners, resulting in poor service or unacceptable risks. If you really want an investment manager who is well regarded in the market, then you must be willing to pay the price. You must also be realistic in understanding that the top investment managers do not generally run individually tailored, direct equity portfolios for small investors, which is one of the main arguments for smaller investors to use mutual funds, or some other form of pooled or unitised investment vehicle.

The client's interests are best served by entering into a realistic arrangement which takes proper account of the sup-

plier's need to run his business on a profitable basis and this balance lies is a matter of fine judgment, which often depends on individual circumstances.

Even when you are satisfied, however, with the estimated level of charges, there are numerous different ways in which they can be calculated, which may influence the behaviour of the investment manager and thus create further potential conflicts. On the face of it, a flat annual fee is the most suitable arrangement, but - as stated above - clients' reluctance to pay adequate fees on this basis has led suppliers to supplement their revenues with alternative charging systems.

Many clients are receptive to fees linked to the return on their investment portfolio, but this may induce the manager to take unacceptable risks in endeavouring to maximise income. Other clients are more receptive to traditional transaction fees, but these clearly provide a temptation to 'churn' the portfolio.

Investment managers are frequently criticised for boosting their revenues by using 'in house' mutual funds, rather than selecting investment product from a wide range of suppliers, in the client's best interests. This criticism is all very well, provided the client is actually willing to pay the additional costs of selecting and monitoring product from so many different sources. In any event, you need to decide whether you are paying someone to manage your investments (in which case why should he delegate the task?) or whether you are paying him to manage a portfolio of external managers - in the latter case, just how many layers of management input are really sensible, or economically viable, as the potential for superior returns can be totally absorbed in additional charges.

Maslinski: clients must be aware what they are buying

Some banks, indeed, make a virtue of having privileged access to investment product, originated in their in-house investment banking arms, which initiate public offerings from their corporate clients. On the face of it, there appears to be a clear conflict of interest between the private fund management client and the corporate investment banking client, but there are many very wealthy and sophisticated private clients who are fully convinced of the advantages.

Private client managers are frequently criticised for inadequate performance measurement systems and it seems clearly in the clients' interests for their performance to be regularly compared against competitors and against market indices. Even here, however, there are dangers of conflicting interests, as performance measurement tends to encourage managers to take a short term view, despite having told their clients that a long term view is an essential prerequisite to successful equity investment.

There is evidence that underperforming managers can be tempted into taking higher risks to make up lost ground and that those with above average performance tend to become more cautious. In any event, investment strategies which underperform one year can frequently outperform the next - and institutions can be 'panicked' into making premature changes, which are not in the long term interests of the client. For clients who actually change their managers as a result of underperformance, research by PricewaterhouseCoopers shows that 60 percent of pension funds which have changed investment managers would have done better to stay where they were!

We have only dealt with a selection of the many conflicts which can and do arise in managing private client investments. There is frequently no single right solution, which can be enshrined in regulation - and the choice of arrangement is often a matter of individual circumstances and personal preference. It is, however, in the clients' interests to understand the issues and to be aware of the alternatives. In particular, they must be aware whether they are buying product or advice and, if the latter, how they are paying for it.

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Intermediaries who are regularly in a position of influencing such decisions will increasingly feel pressure to develop more detailed and analytical understanding of the market, if they themselves are to avoid any accusations of conflict, especially if they benefit in some way from the introductions which they make.

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