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David Thomson: Splitting advice from financial products is a clear improvement

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IF YOU get what you pay for how much value should you place on something you seem to get for nothing? That paradoxical question lies behind much of the way that financial products have been sold in the UK. In many situations the financial adviser is not paid directly by the person they are advising but rather takes a commission from the investment pr
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oduct provider for whom they are acting as a middleman or woman.

But not for much longer – the Financial Services Authority, the savings watchdog, is changing the way such products are sold. The FSA last week began work on fine-tuning new measures proposed under its Retail Distribution Review. This follows the close of its consultation period at the end of October.

These changes will see the separation of what the consumer pays for full and focused advice and what they pay for the financial product – if they decide after the specially tailored advice they receive that that is the best route for them to pursue.

I believe that these changes are an important step on the way to improving quality and transparency in the sale of financial services.

A key part of that will be ensuring that financial products that consumers buy are the ones that most suit them – and that does not mean automatically buying the cheapest.

When you are buying a car you would not always do that. Most people would also wish to consider a whole host of other factors such as performance, whether there was a TV in the rear headrests and the availability of reliable and local dealer service.

The same is true with financial services. Cost is merely one factor from many when considering which product to purchase. And it is far from being the most important. Of critical importance is that the product should meet your needs – you wouldn't buy a two-seater sports car if you regularly had to transport a family of two adults and three teenage children.

Neither should you buy a high risk, potentially high reward, emerging market fund when you want to be reasonably assured of the return of your original capital and want to have ready access to that capital at any time. In such circumstances, a building society account would be a much more appropriate choice.

In addition to suitability, the investment performance of the product and the risk inherent in producing that performance are very important factors that need to be considered. These factors will often outweigh the impact of a slightly higher charge here or there.

Too much emphasis appears to be placed on cost and charges, with the consequent danger that consumers will ignore or undervalue the suitability of investment products, their risk and their performance.

Of course, part of the reason for this is that "charges" are much more tangible than "performance" and so, to date, the regulatory authorities have focused on charges to the detriment of these other, more important factors.

This stance is understandable, to a certain extent – investment performance, unlike a simple analysis of charges, is not that easy to measure. For a start, as we are constantly told in investment companies' marketing literature, "past performance is not a guide to future performance". This should not be translated, however, as "past performance should be disregarded".

Even investment performance in isolation is not the perfect solution. You might be very content with a fund that doubled your money in a year. If you later learned that this had been achieved by the fund manager investing in a double or nothing strategy and that this year he had been lucky, you might be less impressed. So it is important to know that your investment manager is not only well-placed to advise on the suitability of products in relation to your financial needs but that he or she is also likely to be well-placed to select suitable products based on their anticipated investment performance.

As the 1997 Bacon & Woodrow survey of unit linked personal pensions put it: "Past performance is an imperfect guide to the future, but the use of past performance statistics is probably the best guide available to gauge future performance provided that is coupled with a clear understanding of how past performance was achieved, an assessment of the current investment style of a management team and a knowledge of whether the individuals responsible for past performance are still in place."

A better, if slightly more complex, method may be to publish the Sharp ratio of products.

This is a measure of risk adjusted returns which its founder William Forsyth Sharpe originally called the "reward-to-variability" ratio.

The ratio analyses the extra return being generated for the extra level of risk taken in an investment product.

And if all of that sounds a bit technical, then effectively what it means is that if these returns are calculated after charges have been deducted then we should have a reasonably clear indication of which products are likely to perform well compared to the level of risk being taken and the cost of buying them.

The result of all these changes means that the investor knows much more clearly, what they are buying, why they are buying it and how well it is likely to perform.

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