The Quality of Financial Advice: What Influences Client Recommendations?

Philippe d'Astous
HEC Montréal

Irina Gemmo
HEC Montréal

Pierre-Carl Michaud
HEC Montréal

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Context

Consumers face increased complexity in financial decisions

- Shifting burden/risk to individuals in retirement planning, investing, decumulation, etc

Financial literacy is low in the population (Yakoboski et al., 2022; Hastings et al., 2013)

- And individuals may be prone to biases in financial decisions
  - Borrowing: Self-control (Gathergood, 2012), present bias (Kuchler and Pagel, 2021)
  - Investment: Disposition effect (Odean, 1998), home bias (Coval and Moskowitz, 1999)
  - Insurance: Annuity puzzle (Inkmann et al., 2011)

Financial education can work (Kaiser et al., 2022)

- But knowledge costly to acquire, so some ignorance might be optimal (Lusardi et al., 2017)

$\Rightarrow$ Professional financial advice might improve individual outcomes

Quality of financial advice

Financial advice is a $60 billion market in the US but sometimes gets bad press

- Fee chasing and misaligned incentives (Inderst and Ottaviani, 2012; Hackethal et al., 2012)
- Biased against women (Bucher-Koenen et al., 2021; Bhattacharya et al., 2020)
- Dishonest (Egan et al., 2019; Law and Zuo, 2021)

Even if we don't think advisors are malicious

- They tend to recommend a similar portfolio to their clients (Foerster et al., 2017)
- And the portfolio they recommend tends to look like their own (Linnainmaa et al., 2021)

If advisors are themselves prone to certain biases
$\Rightarrow$ They may project these biases in client recommendations
(e.g. through recommending product they are familiar with)

Assessing financial advice

Assessing the quality of financial advice can be hard:

- Self-selection into advice (Bhattacharya et al., 2012; Calcagno and Monticone, 2015)
- Client involvement (Hackethal et al., 2018)
- Propensity of clients to follow through with advice (Agnew et al., 2018)
- Difficult to establish the counterfactual (Chalmers and Reuter, 2020)

Audit studies are possible (e.g. Mullainathan et al., 2012)

- But real client-advisor experiments can be limited by best practices

What we do

Artefactual field experiment/survey with 1,044 Financial Planners in Canada

- Certified planners with higher requirements than the typical bank advisor
  - IQPF in Québec, and FP Canada in the ROC

Investigate how familiarity affects planners' recommendations in four domains (twice)
1. Retirement savings 2. Decumulation 3. Long term care 4. Investments

Survey content

- Demographics, vignettes, employment and licenses, financial products, preferences
- Rewards: 20 Amazon e-gift cards ($50 - $500) + optional 0.5 CE credits

Sample and methods

FPs on average 50 years old, 16 years of experience, and earn $180,000/year ‣ Desc. Stats

- Sample is representative in age and gender (but better educated) ‣ Representative

Randomized variation in scenarios to vary the relative appeal of products

- e.g. investment fees, tax incentives, client health, APR on debt, etc.
- Gender effects, client involvement, compensation

Average partial effects from multinomial logit

- Y_i the product advised to client out of the choice set
- Explanatory variables can be FP-, vignette-, or domain-specific

Familiarity measures: owning, spouse owning, or licensed to sell the product ‣ Familiarity

Investment vignette

Your client, Kate is a 45-year-old female high school teacher with an annual gross income of $50,000. She is married and has two kids under the age of 10. Her husband is currently looking for a job in marketing. Kate currently holds $75,000 in her TFSA and this year, there is no room to contribute to her RRSP (because she holds a DB pension). The mortgage on her house is fully paid off and the line of credit on the house is unused. Kate has $40,000 in a savings account that she is looking to invest (within her TSFA) for a time-horizon of three years. She inquires about the option of investing in an exchange-traded fund (ETF).

From the four options below, which one would you recommend first to Kate?

Recommendations to choose from

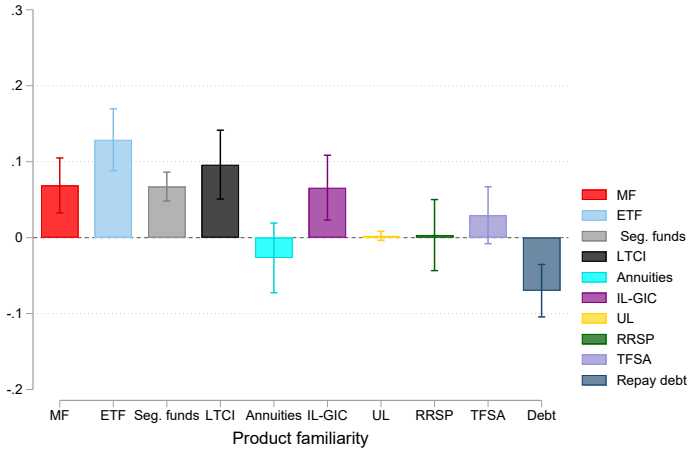
1. Index-linked 3-year GIC
2. Mutual Fund
3. Segregated Fund
4. ETF in self-directed account

Randomized parameters

- Name-gender of the client
- Segregated funds fees (2%, 3%, or 4%)
- Mutual fund fees (1%, 2%, or 3%)
- Client inquires about ETFs

▸ Retirement ▸ Decumulation ▸ Long-term care

Propensity to recommend familiar products



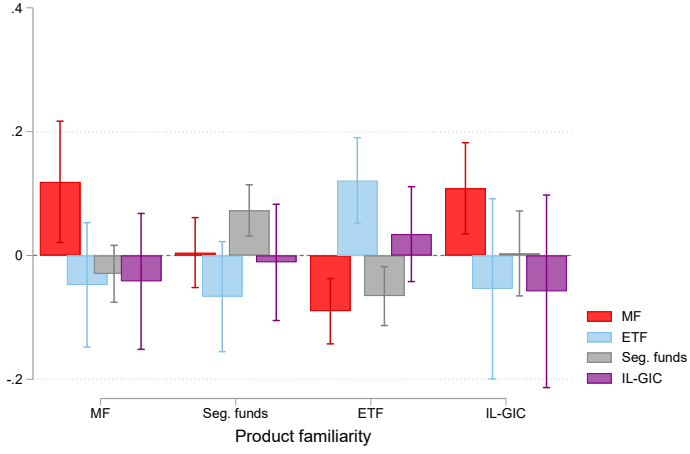
▸ Ownership ▸ Spouse ownership ▸ Licensed to sell

Advice is (mostly) in-line with economic intuition but affected by familiarity

1. Retirement savings vignette
   - More likely to recommend optimal products ▸ Randomizations
   - But less likely to recommend paying debt when levered ▸ Familiarity
2. Decumulation vignette
   - Move away from (partial) annuities if poor client health or bequest motive ▸ Randomization
   - But more likely to recommend (partial) annuities when familiar ▸ Familiarity
3. Long-term care risk vignette
   - Health status doesn't affect LTCI ▸ Randomization
   - But more likely to recommend LTCI when familiar ▸ Familiarity
4. Investment vignette
   - Less likely to recommend products with high fees (turn to ETFs) ▸ Randomization
   - But more likely to recommend MFs when familiar ▸ Familiarity

Does familiarity influence the quality of recommendations?

Familiarity when seg. funds dominate MFs

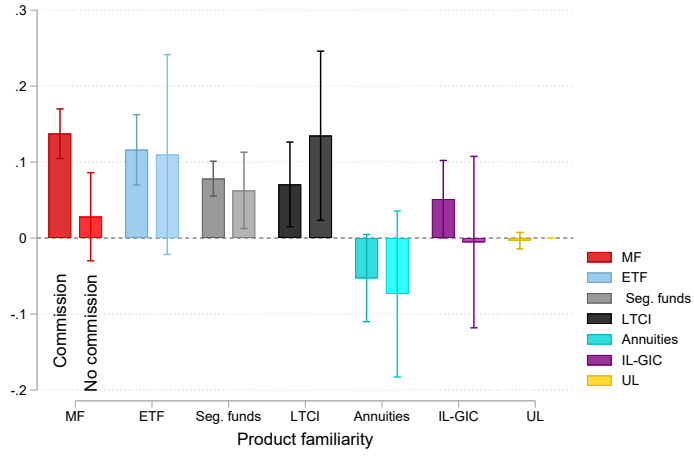


▸ Pooled ▸ Spouse ownership ▸ Licensed to sell

- When seg. funds dominate MFs: More likely to recommend MF if own some

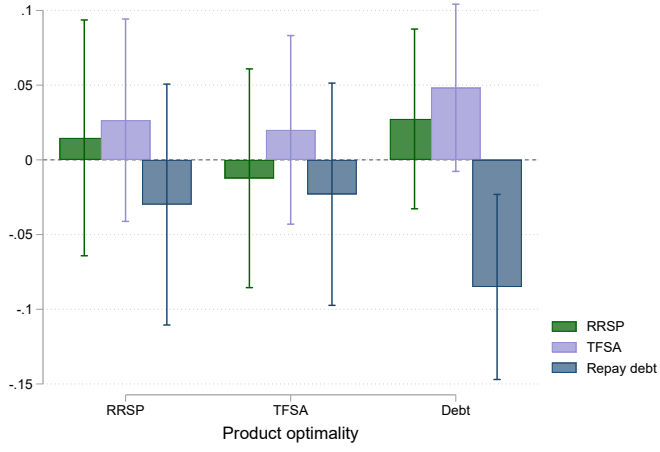
Product familiarity and being paid on commission

▸ More



- More likely to recommend MFs when paid on commission and licensed to sell them

Product familiarity and optimality in retirement decisions



- When debt is optimal: Less likely to recommend repaying debt if levered themselves

Client involvement, gender effects, and return chasing

Effect of client involvement

- Only present in investment when client inquires about ETFs ‣ Results

Gender effects

- Very limited effects, less likely to recommend UL and MFs to female ‣ Results

Not much evidence for return chasing ‣ Results

Conclusion

We investigate familiarity in financial advice recommendations

- Recommendations are mostly in line with economic theory
- But familiarity is important (even for these certified planners) and varies across domains
- Some evidence that product familiarity can influence the quality of advice

If financial literacy is low and financial education is costly $\Rightarrow$ need for financial advice

- But if advisors themselves have biases... clients pay high fees for biased recommendations
- Raising awareness of potential recommendation biases might help lower their prevalence

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Descriptive Statistics

Go back

	Mean	Std. dev.	N
Panel A. Demographics			
Age	49.48	11.74	1,044
Female	0.34		1,044
French survey	0.21		1,044
Married or Common-law	0.82		1,044
Has children	0.77		1,044
Work experience (years)	16.35	9.87	979
Education			
High school or less	0.07		1,044
College or some university	0.20		1,044
Bachelor degree or more	0.72		1,044
Province			
Quebec	0.24		1,044
Ontario	0.39		1,044
Other	0.37		1,044
Financials			
Annual income ('000 $)	178.82	148.29	1,044
Debt ('000 $)	260.25	379.30	1,044

Sample Representativeness

Go back

	FP Canada pop.	Survey sample	
	Mean (std. dev.)	Mean (std. dev.)	Difference (std. err.)
Characteristics			
Age	49.88	49.99	0.11
	(11.63)	(11.57)	(0.42)
Female	0.32	0.32	-0.00
			(0.02)
Work experience (years)	17.62	16.77	-0.86*
	(9.74)	(10.00)	(0.36)
Education			
High school or less	0.15	0.09	-0.06***
			(0.01)
College or some university	0.20	0.21	0.01
			(0.01)
Bachelor degree or more	0.63	0.70	0.07***
			(0.02)

Pooled product familiarity

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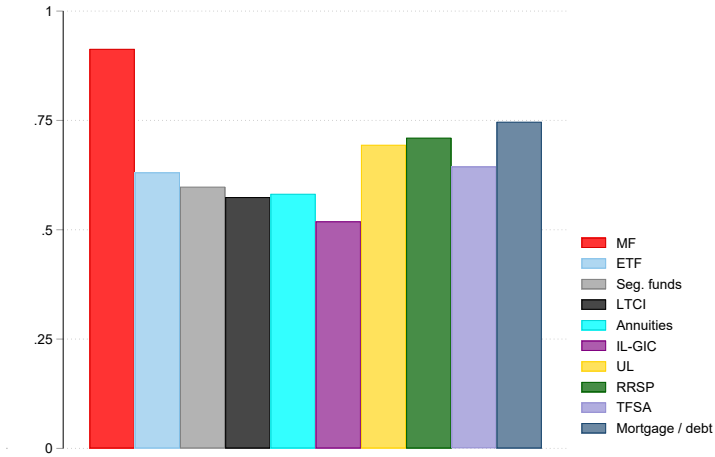

Owning the product

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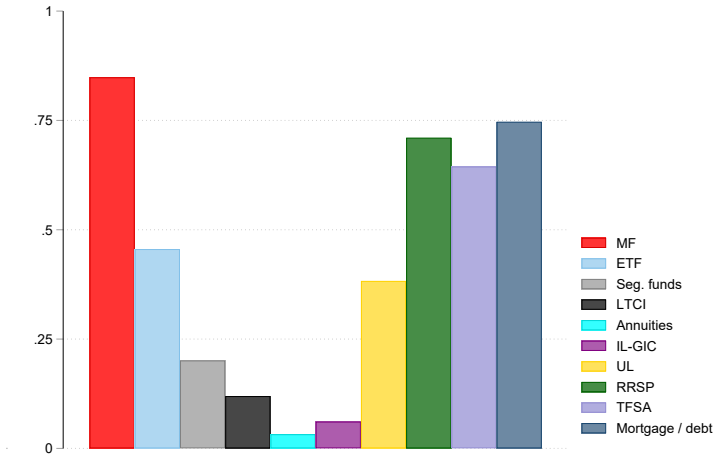

Spouse owns the product

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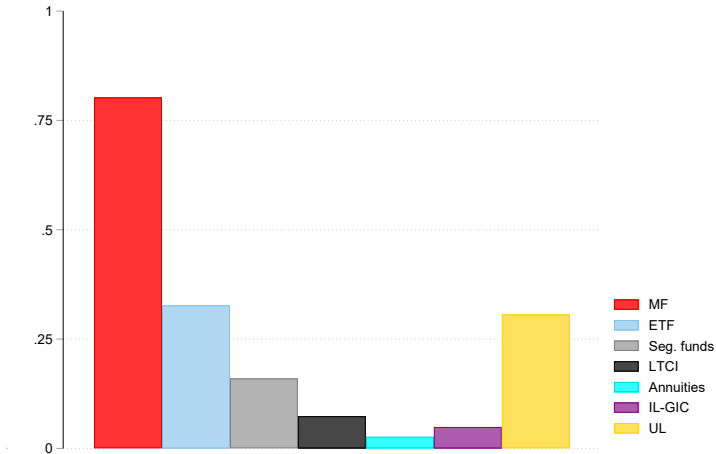

Licensed to sell the product

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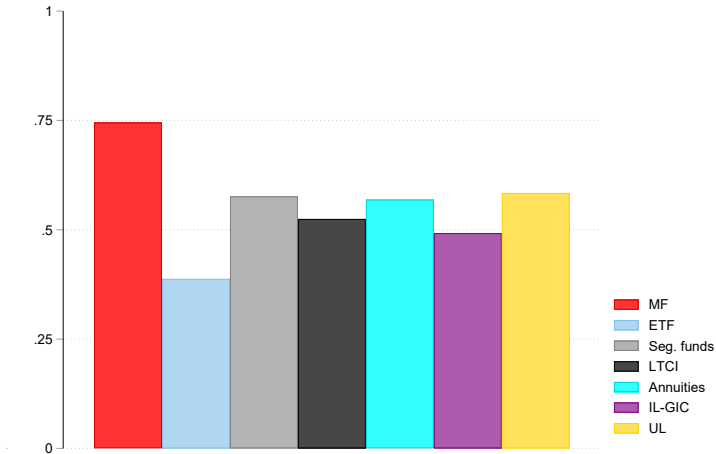

Product familiarity: owning the product

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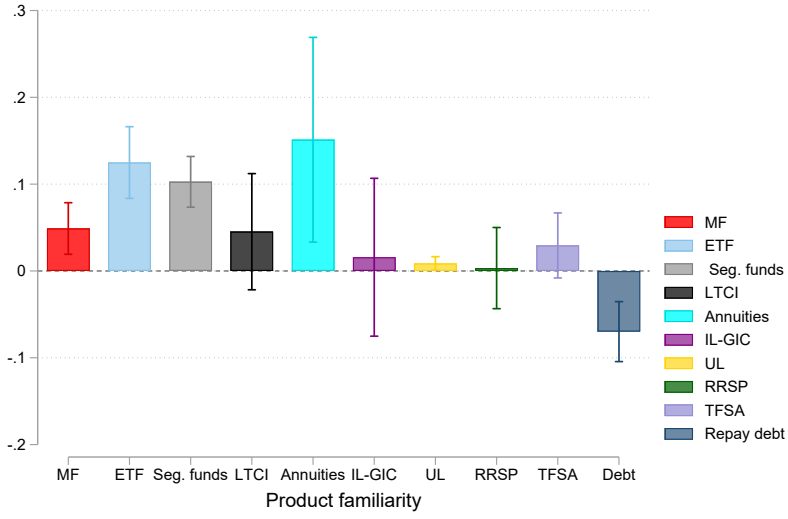

Product familiarity: spouse owns the product

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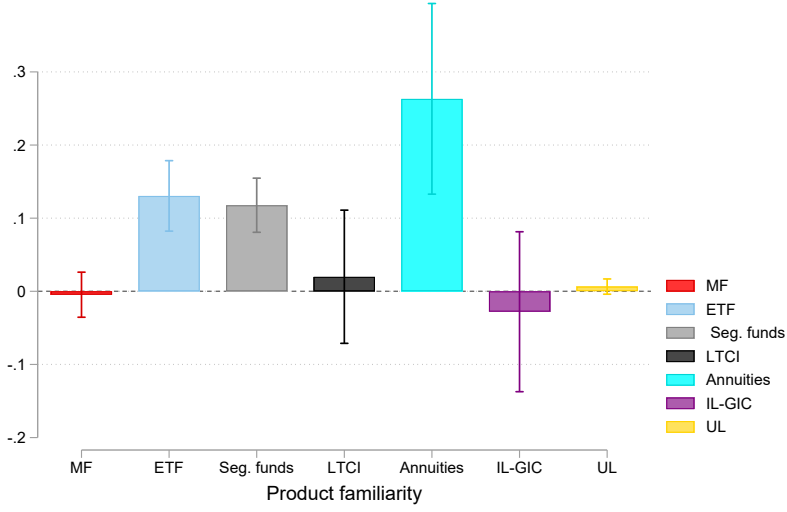

Product familiarity: licensed to sell the product

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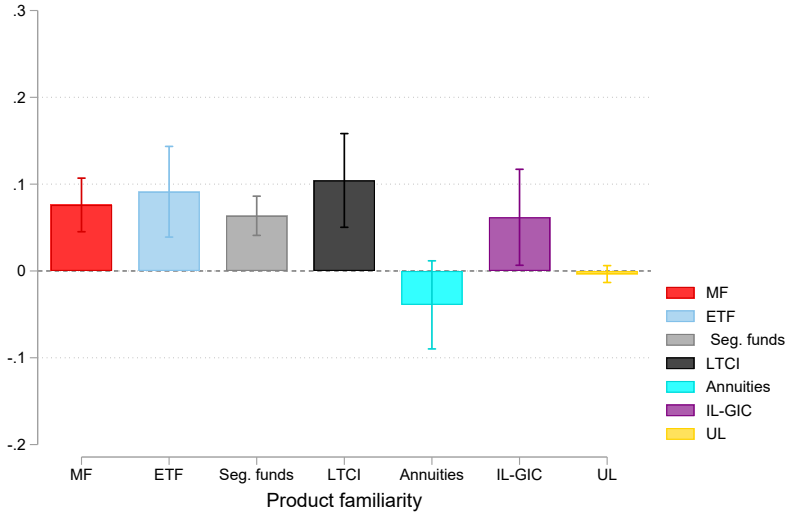

Product familiarity in retirement savings vignette

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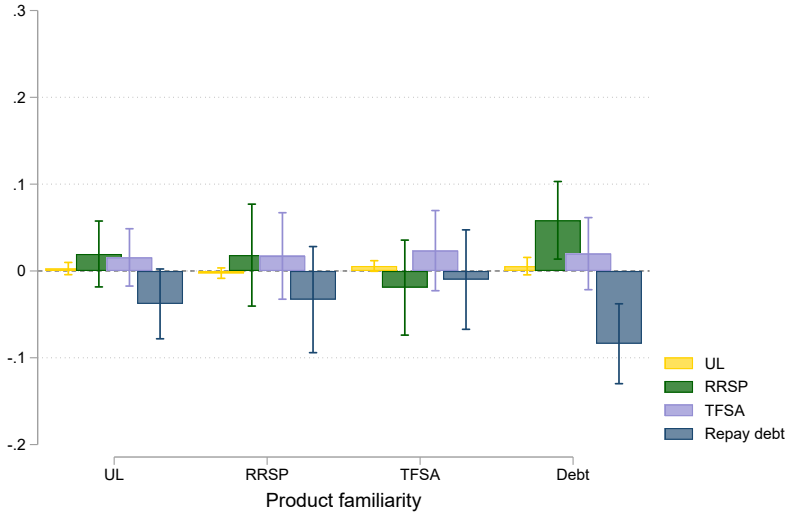

Product familiarity in decumulation vignette

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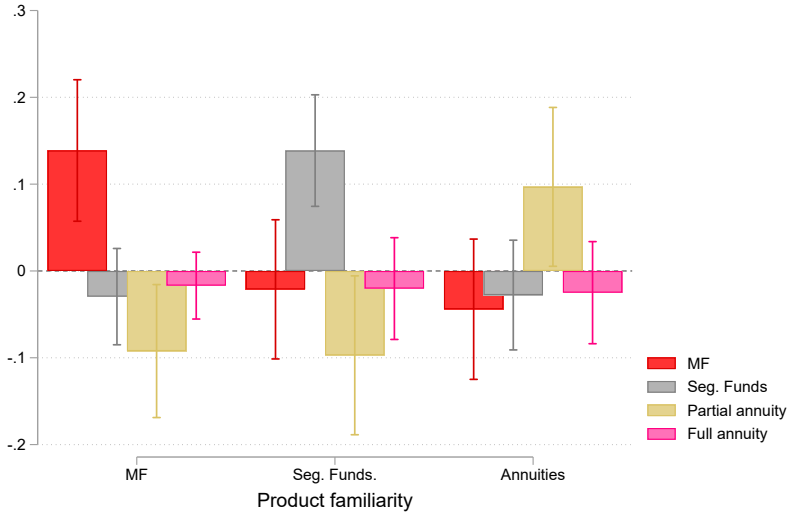

Product familiarity in long-term care vignette

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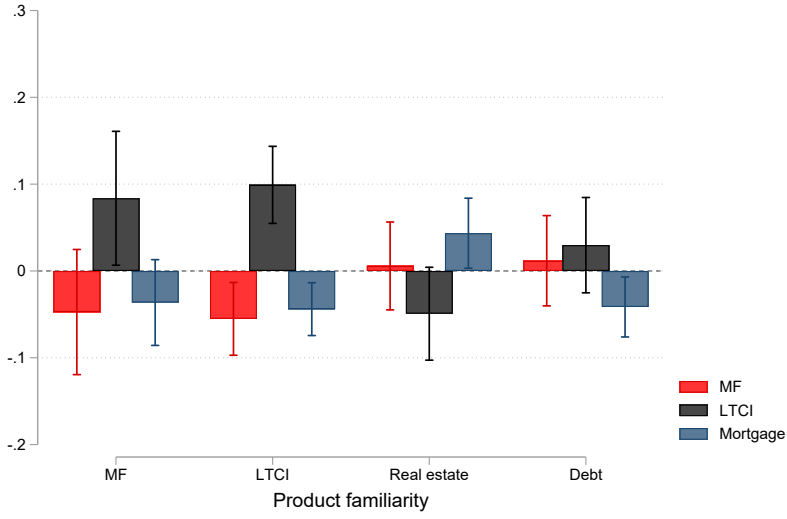

Product familiarity in investment vignette

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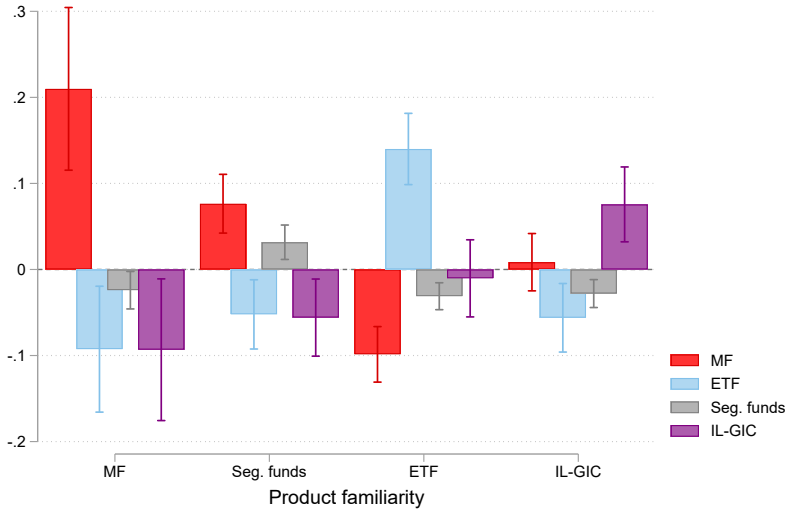

Being paid on commission, licenses and MFs

Go back

	(1)	(2)	(3)	(4)
Paid commissions × Owns MF	0.0581			-0.0271
	(0.0359)			(0.0582)
Paid commissions × Spouse owns MF		0.0362		0.0166
		(0.0381)		(0.0548)
Paid commissions × Licensed for MF			0.1195***	0.1097***
			(0.0314)	(0.0374)
Owns MF	0.0108			0.0561
	(0.0307)			(0.0493)
Spouse owns MF		-0.0267		-0.0684
		(0.0332)		(0.0480)
Licensed for MF			0.0185	0.0240
			(0.0270)	(0.0309)
Paid commissions	-0.0469	-0.0292	-0.1076***	-0.0987***
	(0.0319)	(0.0335)	(0.0221)	(0.0375)
R^2	0.012	0.009	0.018	0.017
Observations	5,814	4,788	5,814	4,788

Effect of returns on mutual fund recommendation

Go back

	(1)	(2)	(3)
Rate on Mutual Funds returns (2% omitted)			
3%	0.0827***	0.0835***	0.0919***
	(0.0247)	(0.0245)	(0.0237)
4%	0.0531**	0.0531**	0.0512**
	(0.0245)	(0.0244)	(0.0232)
5%	0.1873***	0.1858***	0.1916***
	(0.0251)	(0.0252)	(0.0235)
6%	0.0798***	0.0793***	0.0832***
	(0.0247)	(0.0245)	(0.0240)
10%	-0.0067	-0.0069	0.0045
	(0.0232)	(0.0232)	(0.0222)
Controls?	NO	YES	YES
FP FE?	NO	NO	YES
R^2	0.019	0.053	0.412
Observations	4,176	4,176	4,176

Effect of client involvement

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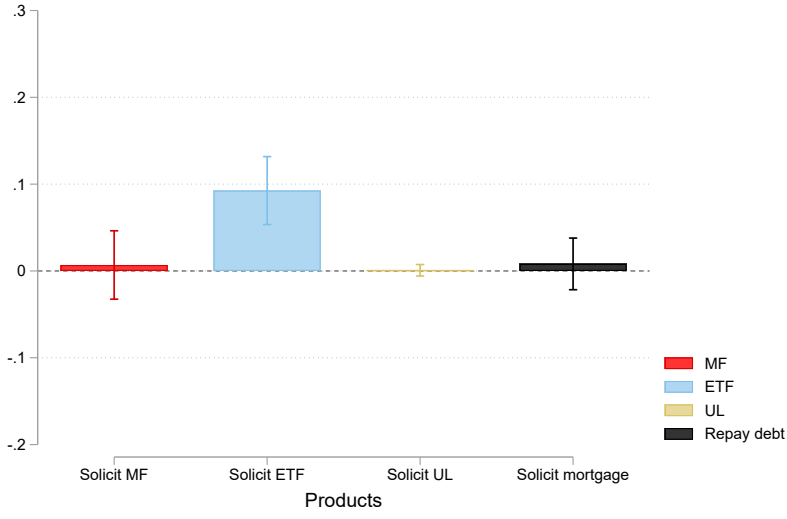

Effect of gender

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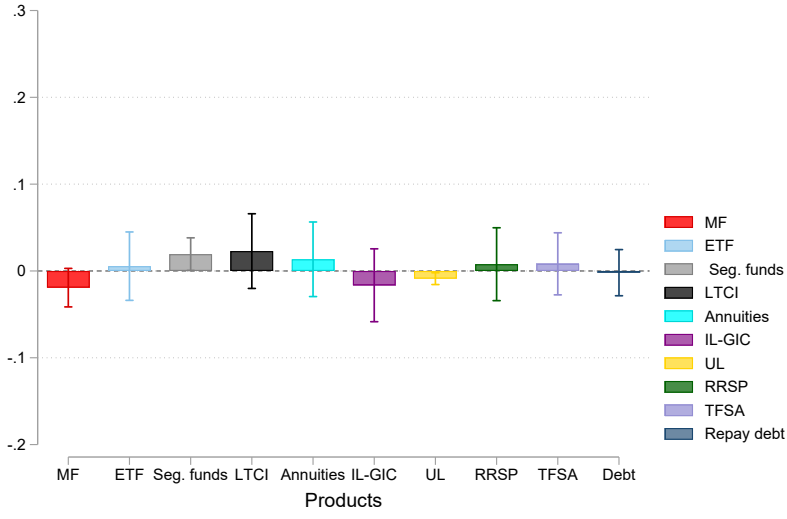


Retirement savings vignette

Go back

Recommendations to choose from

1. Invest the money in an RRSP (e.g., a broad index, such as the TSX)
2. Invest the money in a TFSA (e.g., a broad index, such as the TSX)
3. Invest the money in the UL policy
4. Repay the outstanding debt

Randomized parameters

- Current marginal tax rates (30% or 50%)
- Interest rate on debt held by the client (APR is 2.5%, 5%, or 7%)
- Name-gender of the client
- Client involvement through a prompt for universal life insurance

Decumulation vignette

Go back

Recommendations to choose from

1. Invest in a diversified portfolio of stock and bond MFs earning an expected annual return of 4%.
2. Purchase a $10,000 per annum life annuity with a 10 year payout guarantee with $163,265.31 of her retirement savings and invest the remainder in a diversified portfolio of stock and bond MFs earning an expected annual return of 4%.
3. Invest all retirement savings in a seg. fund yielding annual income of $15,750.
4. Invest all retirement savings in a life annuity with a 10 year payout guarantee yielding $21,437.50 in annual payout.

Randomized parameters

- Name-gender of the client
- Family situation of the client
- Health of the client
- Exp. annual return on MFs (4%, 6% or 10%)
- Payout on seg. funds ($15,750 or $14,000)
- Client involvement through prompt for MFs
- A note stating that the sale of MFs contributes towards the planner's compensation

Long-term care risk vignette

Go back

Recommendations to choose from

1. Pay off his mortgage with his retirement savings.
2. Invest his retirement savings in stock and bonds mutual funds at an expected after-tax return of 2% per year and use this capital to fund long-term care expenses
3. Purchase a long-term care insurance policy for a cost of $280 per month. The benefit would be of $2,000 per month should he require long-term care.

Randomized parameters

- Interest rate on mortgage (1.5%, 2.5%, or 3.5%)
- Health status (Excellent, average, poor)
- Return on mutual funds (2%, 3%, 5%)
- Name-gender of the client
- Client involvement through a prompt for repaying the mortgage

Randomizations in retirement savings vignette

Go back

	RRSP	TFSA	DEBT	UL
1. Retirement savings				
MTR when working (30% omitted)				
50%	0.422***	-0.277***	-0.144***	-0.001
	(0.01)	(0.01)	(0.02)	(0.00)
APR on debt (2.5% omitted)				
5%	-0.138***	-0.136***	0.278***	-0.004
	(0.02)	(0.02)	(0.02)	(0.00)
7.5%	-0.206***	-0.253***	0.463***	-0.003
	(0.02)	(0.02)	(0.02)	(0.00)

Randomizations in decumulation vignette

Go back

	MF	Seg fund	Part. Annuity	Full Annuity
2. Decumulation				
Bequest motive? (*None* is omitted)				
Yes	0.06***	0.07***	-0.05**	-0.07***
	(0.02)	(0.02)	(0.02)	(0.01)
Health status (Excellent omitted)				
Average	0.01	-0.00	-0.03	0.02
	(0.02)	(0.02)	(0.03)	(0.01)
Poor	-0.01	0.11***	-0.14***	0.03**
	(0.02)	(0.02)	(0.03)	(0.01)
Rate on Mutual Funds returns (4% omitted)				
6%	0.03	-0.03	0.01	-0.00
	(0.02)	(0.02)	(0.03)	(0.01)
10%	-0.07***	0.04*	0.02	0.01
	(0.02)	(0.02)	(0.03)	(0.01)
Payout on Seg funds (15,750$ omitted)				
14,000$	0.01	-0.02	-0.01	0.02
	(0.02)	(0.02)	(0.02)	(0.01)
MF sales comission	-0.08***	0.04**	-0.02	0.06***
	(0.02)	(0.02)	(0.02)	(0.01)

Randomizations in long-term care vignette

Go back

	MF	LTCI	Mortgage
3. LTCI			
Borrowing rate (1.5% omitted)			
2.5%	-0.07***	-0.02	0.09***
	(0.02)	(0.03)	(0.02)
3.5%	-0.12***	-0.02	0.14***
	(0.02)	(0.03)	(0.02)
Health status (Excellent omitted)			
Average	-0.03	0.05*	-0.01
	(0.02)	(0.03)	(0.02)
Poor	-0.07***	0.03	0.03*
	(0.03)	(0.03)	(0.02)
Rate on Mutual Funds returns (2% omitted)			
3%	0.08***	-0.02	-0.06***
	(0.03)	(0.03)	(0.02)
5%	0.18***	-0.09***	-0.09***
	(0.02)	(0.03)	(0.02)

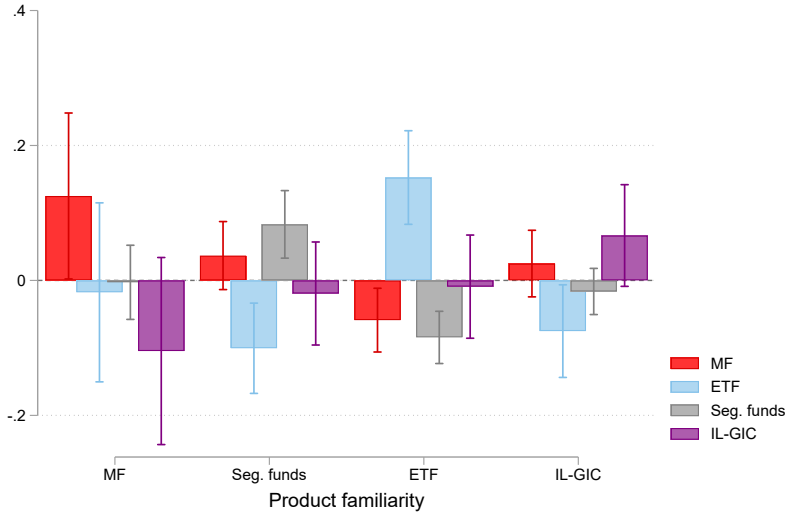
Randomizations in investment vignette

Go back

	MF	Segfund	ETF	GIC
4. Investment				
Mutual Fund fees (1% omitted)				
2%	-0.07***	0.00	0.06**	-0.00
	(0.02)	(0.01)	(0.02)	(0.03)
3%	-0.16***	0.02**	0.10***	0.03
	(0.02)	(0.01)	(0.02)	(0.03)
Segfund fees (2% omitted)				
3%	0.02	-0.02*	0.01	-0.01
	(0.02)	(0.01)	(0.02)	(0.03)
4%	0.02	-0.03***	0.00	0.01
	(0.02)	(0.01)	(0.02)	(0.03)

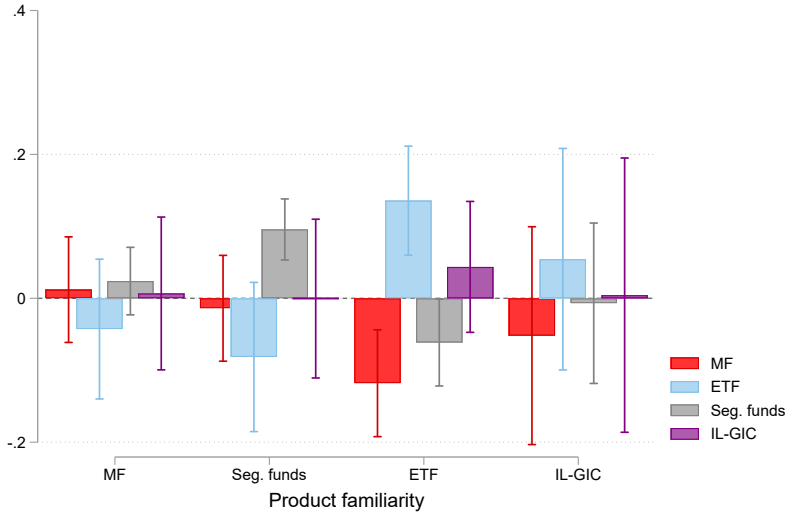
Pooled product familiarity when seg. funds dominate MFs

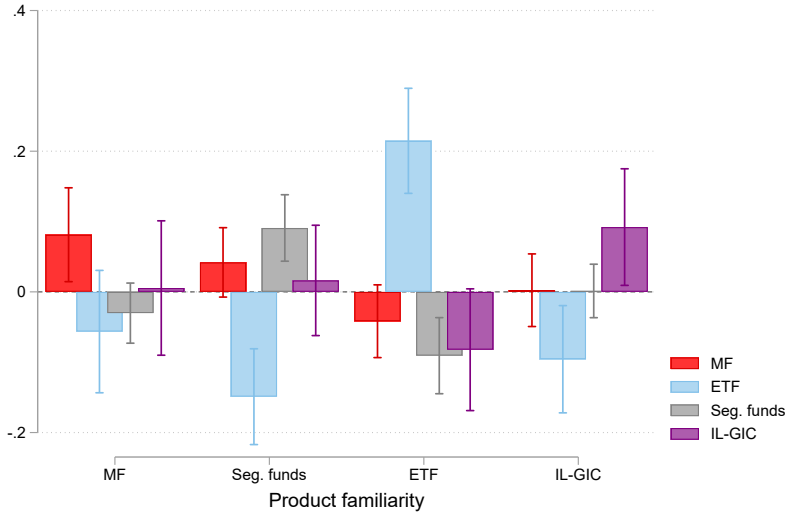
Go back



Spouse owns the product when seg. funds dominate MFs

Go back



Being licensed to sell when seg. funds dominate MFs

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