How to navigate changes in valuation and fee calculation methods

When an investor drops a financial advisor, lack of communication or responsiveness is a factor nearly half the time, says a CFA report

By CFA Society Singapore Advocacy Team

IN a CFA Institute global trust survey report released in mid-2020, 48 per cent of the 100 retail investors who had at least US$100,000 in investible assets in Singapore said that "lack of communication or responsiveness" is a consideration to leave a financial adviser.

Fifty-nine and 36 per cent said the same in similar findings in 2018 and 2016, respectively.

Lack of communication was also one of main reasons, in addition to underperformance, high fees and data confidentiality breach, to drop an adviser.

Communication with clients

As a global body for investment professionals, CFA Institute has clear standards when it comes to communicating with clients and prospective clients. The institute deems developing and maintaining clear, frequent, and thorough communication practices as critical to providing high-quality financial services to clients.

When clients understand the information communicated to them, they also can understand exactly how managers are acting on their behalf, which gives clients the opportunity to make well-informed decisions about their investments. Such understanding can be accomplished only through clear communication.

Managers must:

- Disclose to clients and prospective clients the basic format and general principles of the investment processes they use to analyse investments, select securities and construct portfolio. They must promptly disclose any changes that might materially affect those processes.
- Disclose the significant limitations and risks associated with the investment process.
- Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications.
- Distinguish between fact and opinion in the presentation of investment analyses and recommendations.

How to comply

Because the selection of relevant factors is an analytical skill, determination of whether one has used reasonable judgment in excluding and including information in research reports depends heavily on case-by-case review rather than a specific checklist.

Managers should encourage their firms to have a rigorous methodology for reviewing research that is created for publication and dissemination to clients.

To assist in the after-the-fact review of a report, one must maintain records indicating the nature of the research and should, if asked, be able to supply additional information to the client (or any user of the report) covering factors not included in the report.

When clients understand the information communicated to them, they also understand how managers are acting on their behalf, which means clients make better investment decisions. ILLUSTRATION: PIXABAY

Ethics in action

Here is a case to illustrate how the Communication with Clients and Prospective Clients Standard works. The case is adapted from material developed by CFA Institute. As a guide, the desired ethical behaviour is based on the CFA Institute Code of Ethics and Standards of Professional Conduct (Code and Standards).

Case: Changes in valuation and fee calculation methods

Benigno works in a branch office for a large wealth-management firm in Singapore. The firm's fees are based on a percentage of the value of the assets managed in each client account.

The firm has a standard method for valuing assets and calculating fees for all clients, which is disclosed to each client at the outset of the relationship. Over time, the firm transitions to (1) using the market value of client assets at the end of the billing cycle instead of the average daily balance of the account; (2) including assets in the fee calculation, such as cash or cash equivalents, that were previously excluded; and (3) charging clients for a full billing period rather than pro-rating fees for clients that start or terminate accounts mid-billing period. How or what should Benigno communicate to clients and prospective clients?

This case involves the Communication with Clients and Prospective Clients Standard, which requires him to disclose to clients the basic format and general principles of the investment process.

Advisory fees are a critical part of the investment management process. In the 2020 CFA Institute global trust survey report, "fees are too high" was one of the key considerations to leave a financial advisor. Forty-eight percent of respondents cited high fees as being on par with lack of communication as factors in dropping an advisor.

Developing and maintaining clear, frequent and thorough communication with clients will enable clients to make well-informed decisions about their investments, including whether to engage or retain an adviser.

Any changes to the methods for valuing assets or calculating fees that differ from the process set out and agreed to by the client must be disclosed. It is improper to change fee calculation methodology without disclosure even if it results in lower fees.

Using end-of-cycle valuations, including cash equivalents, or not prorating fees for newly acquired or terminated clients is a possible method for calculating fees as long as those policies are disclosed and agreed to by the client.

It is also permissible to change valuation and methodology and fee calculation policies over time for existing accounts. Benigno and his firm can negotiate with their clients about changes the methods for calculating fees. He must notify his clients of the changes in the valuation and fee calculation methods. This is good practice and will improve trust in Benigno, his firm and the financial sector.

This column has been adapted from content by CFA Institute and is printed here with permission from CFA Institute. The writers are CFA Charterholders who volunteer with the Singapore chapter on advocacy issues with a view towards promoting financial literacy among retail investors. The case is based on a US SEC Office of Compliance Inspections and Examinations Risk Alert.