

*“The Effect of Advisors’ Incentives
on Clients’ Investments”*

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*CEPR European Conference on Household Finance 2020
Online Conference – September 09–11, 2020*

What I really liked about this paper

- A **relevant** study with both academic and practical implications:
 - ▶ Financial advice is **pervasive** in many developed countries.
 - ▶ Heated debate worldwide on how to **regulate** the financial advisory industry.
 - ▶ Evidence that both **conflicts of interests** and **misguided beliefs** might matter.
- An **impressive** empirical setting and **careful** data analysis:
 - ▶ One European investment firm with **variation** in advisors' compensation
 - ▶ Across mutual funds for the **same advisor**
 - ▶ Across advisors for the **same fund**
 - ▶ A **change** in the compensation policy introduced by MIFID II
- A **polished** paper with already **lots** of robustness checks

Outline

- Major comments
 - ① Contribution to the existing literature
 - ② Identification challenges
- Additional comments
 - ③ Economic magnitudes
 - ④ Additional tests
 - ⑤ External validity
- Final remarks

I. Conflict of interests vs. misguided beliefs

Advised clients exhibit **poor** performance

- The typical compensation scheme creates **agency conflicts**:
 - ▶ Bhattacharya et al. (2012), Hackethal, Inderst, and Meyer (2012), Mullainathan, Nöth, and Schoar (2012), Anagol, Cole, and Sarkar (2013), Christoffersen, Evans, and Musto (2013), Chalmers and Reuter (2015), Gennaioli, Shleifer, Vishny (2015), Hoechle, Ruenzi, Schaub, and Schmid (2015), Egan, Matvos, and Seru (2019),...
- Poor performance might stem also from **misguided beliefs**:
 - ▶ Dvorak (2015), Foerster et al. (2017), Linnainmaa, Melzer, and Previtro (forthcoming)

I. This paper contribution

- Egan (2019) uses a novel (reverse) convertible bond dataset:
 - ▶ Brokers make two-times greater fees selling dominated bonds.
 - ▶ Brokers are remunerated in the form of a “kick-back” that investors do not observe.
 - ▶ Product are “relatively simple” and it is possible to rank-order them.
- Egan, Ge, and Tang (2020) study variable annuity sales.
 - ▶ Variable annuity sales are five times more sensitive to brokers' than investors' incentives.
 - ▶ After the 2016 DOL regulation that imposed fiduciary duty to brokers, sales of high-expense annuity fell by 51%
 - ▶ Using a structural model, the authors find that investor welfare might have improved as a result of this fiduciary role.
- Anagol, Cole and Sarkar (2016) and Gambacorta et al. (2020) find similar results in the insurance and mortgage markets.

I. This paper contribution

Suggestions (I):

Reverse convertibles, variable annuities are **opaque** and **high-cost** products:

- Similarly, insurance and mortgage products can be opaque and expensive.
- The authors study investment decisions in a setting where products are more **transparent** and **competitive**.
- Theoretical literature on obfuscation in financial products (e.g., **Carlin (2009); Carlin and Manso (2011)**)
- **Berk and van Binsbergen (2019)** document that, under plausible assumptions, reducing the number of charlatans **lowers consumer surplus**.

I. This paper contribution

Suggestions (II):

The authors have information on the **personal portfolios** of financial advisors:

- In general, this information would allow to disentangle conflicts of interests from misguided beliefs.
- Here, it could allow to infer which advisors are **more attentive** to the change in the fee structure(*).

II. Identification: the ideal set-up

- The ideal empirical set-up: **randomly** vary fee structure across advisors and study clients' allocations.
 - ▶ Obviously, changes in fee structure are not random.
 - ▶ Originally, fees vary across **cohorts of advisors**.
 - ▶ In January 2018, overhaul of firm compensation due to **MIFID II**.
- In practice, the results in the paper **could** be driven by:
 - ▶ Which **cohort of advisors** has the highest gap (reduction?) in fees and/or
 - ▶ **other relevant changes** that were introduced by the MIFID II.

II. Identification challenges: “cohort effects”

- Different advisors were subject to **different financial incentives**:
 - ▶ “...the main reason...was the combination of advisors joining at **different times** and the stickiness in contractual arrangements”.
 - ▶ It is sensible then to hypothesize that **different cohorts** of advisors are facing different incentives.
 - ▶ Given the trend towards **lower financial fees**, older cohorts face **higher incentives** to reallocate their client portfolios after MIFID II.
- **Advisor fixed effects** would account for these cohort effects.
 - ▶ It's not about the magnitude of the results, but about their **interpretation**.
 - ▶ For which advisors do fees substantially change?
 - ▶ Are we identifying the effects off older/ longer tenured advisors?
- The effect of fees is **higher** for **high-tenure** clients.
 - ▶ This result is also consistent with the cohort story.

II. Addressing identification challenges (I)

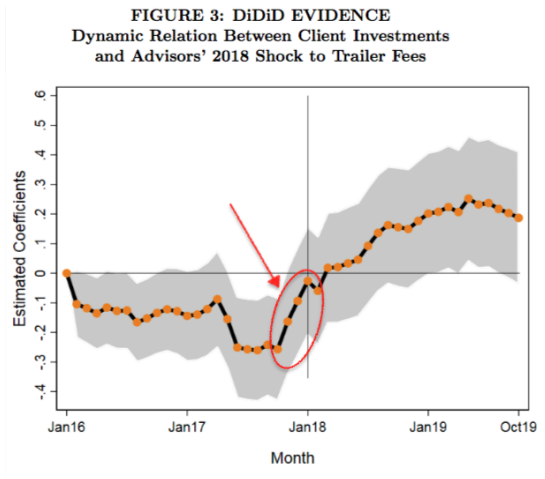
Suggestions:

- We need to better understand the **raw data**:
 - ▶ What is the variation in advisor/funds fees **before** and **after** MIFID II?
 - ▶ Do fees **decrease** for all advisor/ funds? Or do they increase for some advisor/funds?
 - ▶ Is the distribution of the variation in fees **skewed**?
- In table 7, Panel B, the authors break down the utility loss for *“advisors with significant changes in compensation contracts”*
 - ▶ What are the **characteristics** of this sample of advisors?
 - ▶ How do they **compare** to the less/non-impacted advisors?
 - ▶ What **fraction of the results** in the paper do they drive?
 - ▶ Note: **advisor heterogeneity** is largely unexplored in the paper.

II. Identification challenges: the introduction of MIFID II

- MIFID II has introduced several changes, including among the others:
 - ▶ Increased transparency of charges.
 - ▶ All advisors need to acquire qualifications within four years.
 - ▶ Plus others less relevant because of staggered introduction by firm.
- Advisor fixed effects would not help in this case:
 - ▶ Because of MIFID II, advisors can strategically change their behavior.
 - ▶ Case 1: advisors could maximize their income before leaving the industry
 - ★ If so, we would underestimate the effect of compensation.
 - ★ Linnainmaa et al. (2020) find that after a regulatory change in Canada many advisors exit the industry.
 - ★ In this paper the effects of fees are stronger for advisors without qualification.
 - ▶ Case 2: advisors could reduce allocations to high-fee investments.
 - ★ If so, we would overestimate the effects of the change in fees.
 - ★ This story would be consistent with anticipatory effects of MIFID II.

II. Identification challenges: the introduction of MIFID II



Note: The anticipation effects (in the **three months before** MIFID II) are as large as the effects in the **following 18 months**.

II. Addressing identification challenges (II)

Suggestions:

- A **triple diff** design could potentially help in this setting:
 - ▶ The paper could benefit from a more “transparent” design (vs. tree-way f.e. model)
 - ★ Control group (A): advisors with **no** change in fee structure
 - ★ Treatment group (B): advisors with **significant** change in fees (T7, B)
 - ★ Additional control group (C): advisors with **modest** change in fees.
 - ▶ This design would allow to more explicitly test if groups A and C are good **counterfactuals** for group B.
 - ★ We have already addressed **covariates balance** between A and B.
 - ★ For triple diff to help we need also balance between B and C.
 - ★ E.g., if group C are mostly younger advisors and group B are older advisors, then **triple diff might not work**.
 - ▶ Large and growing literature in econometrics that argue:
 - ★ Against the use of **two-way fixed effects** models when treatment effects are heterogenous (e.g., Liu, Wang, and Xu (2020), de Chaisemartin and D'Haultfuille (2020))
 - ★ The need for **sensitivity analyses** or different models.

IV. Additional comments (I): economic magnitudes

- Are the economic magnitudes **sensible**?
 - ▶ An **interquartile** increase in fees causing a **13%** increase in investments?
 - ▶ To interpret this magnitude we need to know **how often** a client trades.

Suggestions:

- Investigate **portfolio rebalancing** and **trading activity**:
 - ▶ How often do investors **rebalance** their portfolios?
 - ▶ Do they **buy higher-fee investments** (and sell lower-fee ones)?
 - ▶ Does fee-driven rebalancing also cause **changes in risk-taking**?
 - ▶ What are the estimates if we limit the sample to investors **actively trading** in the sample period?

IV. Additional comments (II): additional tests

- **Pre-trends** are not fully parallel before the event.
- **Falsification tests** could strengthen the evidence in the paper.
- The information on **advisor portfolios** is not fully exploited.

Suggestions:

- Include in the analyses a **time trend variable**.
- Report the coefficient estimates **for each month around MIFID II**.
- For those advisors with negligible change in fee structure, we should find **no effects** after MIFID II.
- If advisors earn their own commissions, they should respond to fee changes with **very high elasticity**.

IV. Additional comments (III): external validity

- The evidence in the paper comes from **one financial institution**.
 - ▶ We have information from **155 advisors**.
 - ▶ Each advisor has **34 clients**.
 - ▶ What is the **average salary** for advisors?

Suggestions:

- To generalize the results in the paper it would be useful to understand **how representative** this firm is:
 - ▶ Can we compare these advisors to ones in other studies?
 - ▶ There is evidence from US, Canada, Germany, UK, Italy...

To conclude

- Really enjoyed reading the paper!
- The authors could strengthen the **contribution**:
 - ▶ Highlight the differences vs. other studies.
 - ▶ Investigate more the role of transparency and (relatively) low prices.
 - ▶ Fully exploit information on advisor portfolios.
- They could also sharpen the **identification**:
 - ▶ Report also results from a more “transparent” design.
 - ▶ From a DiD to a DiDiD, using alternative treatment and control groups.
 - ▶ Investigate more the heterogeneity across advisors (in incentives and other observables).