A super chance to snap up a cheaper deal

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If you're a retail investor with money to invest, you'll generally find there are two ways of going about it. The expensive way and the cheap way.

Looking for a secure product providing a steady income stream? Term deposits have no fees, except for the margin built in to the highly competitive interest rate offered. Or you could opt for a fixed interest or mortgage fund with annual fees of 1 per cent or more.

Want to buy a managed portfolio of shares? Well you could go for an index or exchange traded fund with fees well under the 1 per cent mark, or you might prefer an "active" fund that gives similar performance for an annual fee of 2 per cent or more.

Somewhere to stick your super without having to make lots of decisions yourself? Try an industry or not-for-profit fund with costs of less than 1 per cent. Or maybe you'd prefer a retail fund with double the costs or more.

Just about any investment you can think of has cheap and more expensive alternatives. Yet until now, financial advisers have been much more inclined to funnel their clients into the expensive options - the fixed interest funds, share funds, and retail super - than the cheaper alternatives.

It's no secret why. Commissions have to be paid for by someone, and the cost of commissions - known in the trade as "distribution" - is part and parcel of most commonly recommended investment products. Investments that don't pay commissions tend to be overlooked by advisers, although they often prove popular with direct investors and fee-for-service advisers who know a bargain.

But the government's plan to ban commissions paid to financial planners is about to change all that. With no incentive to do otherwise, advisers will be able to steer their clients into the best products available. And unless the more expensive products get serious about ditching those "distribution costs", the cheaper options should become a lot more popular.

In a survey of brokers and financial advisers this month, Russell Investments found 84 per cent expect to increase their use of Exchange Traded Funds (ETFs) over the next 12 months.

ETFs, as the name implies, are index funds traded on the stock exchange. You can buy and sell ETF units through a broker, in the same way as shares. ETFs track the performance of a wide range of assets - from your standard Australian sharemarket indices to international markets, local market sectors and commodities. But unlike shares, they are open-ended which means the company offering the ETF can issue new units in the fund, or buy up units, to meet investor demand. Market makers control the supply of units on the market to ensure they trade at prices close to the net value of the underlying assets. This distinguishes them from listed investment companies, for example, which generally trade at a premium or discount to the value of their underlying assets.

ETFs are a major growth investment overseas though still in their early days in the Australian market. But with no entry or exit fees other than brokerage, and annual fees as low as 0.09 per cent, they provide a low cost means for investors to get wide exposure to shares and other assets.

Almost 90 per cent of the advisers and brokers surveyed by Russell said ETFs were a suitable product for fee-for-service business models. Yet more than 70 per cent currently allocate less than 5 per cent of their clients' portfolios to the product. According to the Investment Trends 2009 ETF Report, 82 per cent of ETF investors had no adviser involved in their decision to invest.

Along similar lines, a recent Investment Trends report on planner remuneration found planners who preferred commissions were more likely to place clients in managed funds (which pay commissions) while planners that charged fees were much more likely to use direct shares for client portfolios.

If the Financial Services Minister, Chris Bowen, needed further proof that the government's decision to ban commissions was the right one, this is it.

The debate over commissions has rightly focused on extreme examples of investments that generated high levels of commissions and failed. But what is becoming increasingly apparent is that it is not just planners who will have to change the way they operate. Fund managers and other product issuers will also have to shape up.

As more planners shift to a fee-for-service model, consumers will have every right to feel ripped off if they simply end up paying more for what they're getting now. By paying the planner direct, they should get a reduction on the cost of their investments. Or ask a very loud "Why not?".

This means many fund managers and other product providers will be hard pressed to maintain their current fees, especially faced with competition from products that were traditionally the realm of non-advice investors. As the industry super funds have been pointing out for years, even a small difference in fees can add up over the term of an investment.

Of course, cheaper isn't always better and funds that have a track record of adding value will still be able to justify a premium over simpler, cheaper alternatives. But run-of-the-mill investment products that have grown fat on commission-driven recommendations will find the going much tougher.

The supply of alternative, cost-efficient investments is only going to increase now that advisers, along with direct investors, have an incentive to use them.

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