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An Evaluation of External Financial Advisors in the Premium Pension System

Swedish Social Insurance Inspectorate

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Summary

The Swedish Social Insurance Inspectorate (Inspektionen för socialförsäkringen, ISF) is an independent supervisory agency for the Swedish social insurance system. Its objectives are to strengthen compliance with legislation and other statutes, and to improve the efficiency of the social insurance system through system supervision and efficiency analysis and evaluation.

ISF's work is mainly conducted on a project basis and is commissioned by the Government or initiated by the Agency. This report has been initiated by the Agency.

Background

During the last decade, individuals in Sweden have become more involved in investment decisions when it comes to saving for their own retirement. A defined contribution plan called the Premium Pension System (PPS), which is a part of the mandatory Swedish public pension scheme, covers all employees since July 2000, with yearly contributions equal to 2.5 per cent of income. Within the system, future pensioners create their own portfolio with a maximum of five funds containing equities, bonds, or both. If the individual is inactive at entry and no fund choice is made, the savings are invested in a specific default fund, managed by the Seventh AP Fund, which is a state-managed national pension fund. In the PPS, the fund choice can be made from about 800 different funds. The individuals can choose funds on a daily basis and without having to pay for any transaction costs. However, financial planning towards retirement is complex, since the individual must understand and process information regarding risk and return and from this predict future development on the financial markets.

Between 2001 and 2010, an increasing number of savers in the PPS chose to pay an external financial advisor for their investment choices

in the PPS. These external financial advisors, who make discretionary decisions regarding their clients' PPS funds, were responsible for a dramatic increase in activity in the PPS occurring in recent years. The external advisors managed coordinated mass changes of funds for a large number of clients simultaneously through so-called web robots. According to this study, in April 2010 about 8.2 per cent of the pension savers in the PPS hired an external financial advisor for their PPS fund investments. This essentially confirms results from previous studies.

Objectives

In light of this, it is motivated to study how these external financial advisors actually perform. This study investigates, first, whether these advisors are worth their fee for the group that chose to buy this service, and, second, whether the advisors generated higher excess return than individuals who actively managed their funds themselves. Third, the study investigates whether the background characteristics differ between groups depending on the decision to hire an external financial advisor or not.

Methods

The investigation is based on administrative data from the Swedish Pensions Agency, consisting of individual-level data on the monthly account holdings in the PPS. The data cover all savers in the PPS from January 2000 to April 2010. These data are linked to detailed annual administrative registers from Statistics Sweden with data on income, education, financial wealth, and real estate.

Findings

The results show that the group with a financial advisor consists of persons with relatively low education, low financial wealth and high disposable income, who receive income from unemployment insurance or from self-employment more often than others, and who to a greater extent save in a private pension insurance scheme. Individuals who are more active in the PPS without hiring an external financial advisor have relatively high education and income. There is also a large group of relatively passive individuals in the PPS who are outside the default fund and who have no external agent – these were active in the first year when the PPS started but since then have remained passive (i.e., made no change to their initial fund choice). These individuals are similar to those with their PPS wealth in the default fund, e.g., in terms of education level.

The results show that there is, on average, a higher excess return from an external financial advisor for those that have decided to acquire these services. However, the extra excess return is on average small, net of the financial advisor's charge. The results also indicate that the financial advisors significantly reduce the portfolio risk, which should be considered as positive for the individual.

Furthermore, the analysis indicates that the positive effect of external financial advisors is explained by the fact that they are more active and change funds more frequently for their client than the average PPS saver. Individuals who are as active themselves are slightly better on average at generating excess return.

Finally, the analysis shows that individuals who choose to hire an external financial advisor for their PPS wealth are those who can be expected to be relatively inactive in the PPS. Thus, it may be profitable for them to engage an external financial advisor. The implication of this is that financial advisors have generated a higher excess return for their clients than they themselves would have achieved on average had they not chosen this service. Note that the effect of financial advisors is only examined for the group that actually decided on a financial advisor and that the results cannot be generalized to pension savers in general.

Discussion

In December 2011, the ability to mass-change funds was abolished. Therefore the possibility of discretionary fund management of this type in the PPS has been eliminated. The results in this report indicate that this is likely to disadvantage somewhat the group that chose external advisors, since the stopping of coordinated mass changes in practice led to a substantial reduction in the ability to outsource recurring fund-choice decisions to financial advisors.

This must be related to the external effects of coordinated mass changes on other pension savers in the PPS, as noted in previous studies. These studies have shown that the mass changes had negative external effects on other retirement savers (both active and passive) in the form of increased transaction costs and fund value fluctuations, and on the Swedish Pensions Agency in the form of an increased burden on the agency’s IT systems. The present report does not account for these potential externalities.