The Difference Between Value And Price

By Wilfred Ling

In this article, I will provide some illustrations on the value of good and bad financial advice through examples and show why individuals often obtain the worst advice despite paying a huge price for it.

When an investor purchases a stock, he pays the share price. What he gets is "value" of the stock. If the fair value of the stock is above the price he paid, it is an undervalued stock and hence the stock is considered "cheap." Whether the stock is cheap or expensive depends on the relative difference between the stock price and the fair value. The absolute dollar of the stock price cannot tell us whether the stock is "cheap" or "expensive." There are various ways to calculate the fair value of stock. A common method is the dividend discount model.

In financial planning, the value of an advice is more complicated as there is no mathematical model to determine the fair value of an advice. Due to the lack of such precise measurement of value, many people are not willing to pay even a single cent for such planning. On the other hand, it is also true that many financial advisers provide such poor value of services to their clients that they do not deserve to be paid for such service. Ironically many consumers pay a huge price to these advisers through outrageous commissions even without knowing it. In this article, I will provide some illustration on the value of good and bad financial advice through examples and show why individuals often obtain the worst advice despite them paying a large huge price for it.

Mr John Ang (a hypothetical person) was a Singaporean married with children who were about to graduate. John was an established architect who owns this business with another two partners through a partnership. His wife was a housewife. John was a "high-net worth" person with a net worth of $2,000,000 consisting of property, cash, stocks and business. His mortgage loan had a comfortable loan-to-valuation of only 50 per cent.

John was supporting his ageing parents. Some years ago upon the advice of an insurance adviser, John bought a whole life insurance policy insuring himself $500,000 paying an annual premium of $10,000 to Freedom Assurance (a hypothetical insurer listed on the FTSE) and he nominated his parents as beneficiaries. His insurance adviser advised him that if he were to die, his parents would have a significant sum of money and will no longer be financially reliant on anyone.

On December 2008, John met a relationship manager who advised him to invest in US stocks because of the extreme low valuation due to the US facing the worst financial crisis since the Great Depression. John took the advice and made the investment through the relationship manager's discretionary managed account. John also took the opportunity to ask whether his family's financial position was well taken care of if he were to die. The relationship manager felt that his net worth of $2,000,000 plus the $500,000 existing life insurance was more than enough to support his wife's retirement and his ageing parents. Moreover, his two children were about to graduate and will soon no longer need his support.

John's net assets are shown on Table 1. On June 2009, John was notified that he will be sued. Apparently, one of his partners made a mistake which caused a client to suffer a financial loss. As the business was set up as

TABLE 1 - ASSET AND LIABILITY OF MR JOHN ANG AS AT DECEMBER 2008

Residential Property	$800,000
Cash	$200,000
Investments in shares listed in US	$400,000
Architect business	$1,000,000 (principal invested)
Less Mortgage loan	($400,000)
Net asset	**S$2,000,000**

a partnership, John was fully liable for the actions of other partners. Fortunately, John managed to settle the matter out of court by paying $150,000 instead of going through the tedious court process as he did not want the matter to be publicized. Due to this out of court settlement, his cash position decreased to $50,000.

On September 2009, John, being an inexperienced stock investor, was shocked to see his US shares plunge by 10 per cent in just a single night. The shock caused him a heart attack and he died on that night.

After his funeral, Mrs Ang proceeded to apply for the Letter of Administration, as John did not leave behind a Will. However, this application was delayed because under Singapore's regulation, two sureties are required if the estate exceeds $250,000 or if there are minor beneficiaries. For John's case, his estate was worth much more than this. Mrs Ang had a hard time trying to find these two sureties as these two persons effectively need to act as "guarantors" if the Administrator did not manage the estate properly. Finally, she managed to find two relatives to act as sureties. However, thinking that Mrs Ang would stand to inherit a large sum of money, they demanded that they be paid $100,000 each after the estate is distributed.

To Mrs Ang horror, she discovered that the shares in US attracted an estate duty of a whopping $140,000! This is because John invested in US shares as a foreigner. As a foreigner, his estate duty exemption is only US$60,000. For year 2009, the estate duty rate was 45 per cent.

While John may have invested $1,000,000 into his architect firm, none of the existing partners were willing to buy over his share at this amount. In fact, none of his existing partners had so much cash on hand. To make things worse, John's skill and reputation could be replaced. Thus, the partners are only willing to buy over his share at $200,000. Neither Ms Ang nor her two children had any interest in the architecture business. In fact, none of them were even qualified. Thus, they had no choice but to sell John's share at a huge discount to the existing partners.

Out of desperation Mrs Ang sought a lawyer's advice on how to "maximize" the value of the estate. According to her lawyer, nomination of parents in a life insurance issued by the Freedom Assurance was not valid under Singapore's law during the time the nomination was done. John's parents insisted that the $500,000 life insurance proceed belongs to them. Mrs Ang decided to take legal action against John's parents. The legal fee for this lawsuit was estimated to be $300,000.

Since John did not leave behind a Will, the estate had to be distributed according to Interstate Succession Act. Mrs Ang will inherit half while the remaining balance goes to the children. Moreover, due to the lack of liquidity, the property had to be sold at a discount because buyers were superstitions about buying the property of someone who had died. Assuming she wins the lawsuit against her parents-in-law, the estate is only worth $750,000.

In summary, Mrs Ang receives only half of the estate. This is estimated to be just $375,000 which is sufficient only to purchase a HDB flat with no additional cash as balance. Moreover, John parents got nothing. Mrs Ang's children want to start a business with the money and have no wish to help either their mother or their grandparents with their finances. Table 2 shows the updated estate.

Here are some comments on the quality of advice from John's advisers :

- John bought a life insurance with his parents as nominees. This is a bad advice as there was no clear valid law permitting this. A competent financial planner would prefer John not to do any nomination but to specify his wishes in a Will that would had cost a few hundreds of dollars only. Although the insurance adviser earns probably $10,000 in total commissions for selling him the whole life insurance, the advice given was worthless (because John's parents never received the intended proceed). For this case, John paid a huge amount in price via large commissions but received zero in value.
- John did not have any debt cancellation plan and no provision was made to cancel his debt in an orderly fashion. Without proper planning, Mrs Ang has to sell the property to raise cash proceeds. A mortgage reducing term insurance (MRTA) could have easily canceled the debt. Neither of John's two advisers was keen to sell this insurance because commission was too low. The value of the MRTA would have prevented the property from being sold at an unfavorable price. For John, the value of the MRTA is much higher than the "price" (commission). Thus, the MRTA is considered "cheap". Unfortunately, he did not buy this "cheap" insurance because none were willing to sell it to him.
- John's relationship manager provided him with two bad advices. Firstly, the relationship manager did not account for estate duty problem but were keener in "selling" him the discretionary account. Secondly, the relationship manager failed to analyse John's financial position in detail not knowing that his estate value can be much less than his theoretical net worth. Again the relationship manager

TABLE 2 - MR JOHN ANG'S ESTATE AS AT SEPTEMBER 2009

Residential Property	$800,000
Cash	$200,000
Investments in shares listed in US	$400,000
Architect business	$1,000,000 (principal invested)
Add	
Life Insurance for John's parents	$500,000
Sub-total	**$2,900,000**
Less	
Mortgage loan	($400,000)
Out of court settlement	($150,000)
"Payment" to sureties	($200,000)
Estate Duty (US shares)	($140,000)
Write-down - John's architect business	($800,000)
Legal fee to sue John's parents	($300,000)
Property price write-down due to superstition	($160,000)
Net asset	**S$750,000**

earned large commissions by selling the discretionary account but John received poor value. Assuming an upfront fee of 5 per cent, this relationship manager earned $20,000 but provided worthless advice.

HOW A COMPETENT FINANCIAL PLANNER COULD HAVE HELPED JOHN?

- The competent financial planner would not have told John to make any nominations on his life insurance. John should have written in his Will to have the proceeds of the life insurance given to his parents so that there will be no misunderstanding.
- As John has no experience in stock investment, a diversified portfolio of stocks and bonds would have been recommended. A competent planner will not insist in buying certain specified products without taking into account of the investor's experience or the lack of it.
- If John is really keen in US securities, he should have invested via a unit trust or through a portfolio bond rather than holding the securities directly. Holding the securities directly would incur estate duty.
- John's business should not have been set up as a partnership. He should have established it as a Limited Liability Partnership (LLP) or a Private Limited Company so that he would not be responsible for other partners' liabilities.
- If John had a Will written, two sureties would not have been required.
- A mortgage reducing term insurance should be recommended to cancel the mortgage loan and prevent the property from being sold to raise liquidity.
- Finally, the financial planner would have instituted a succession plan consisting of a buy-sell agreement so that his partners would have the money and the legal obligation to buy over John's share of the business on his death at a predetermined value.

Through the above recommendations, John's estate value would have remained intact and assets would have been distributed in an orderly fashion in accordance with his wishes.

Without proper planning, the value of estate is $750,000. With sound planning by a competent financial planner, the value of estate would be $2,900,000.The value of advice provided by a competent financial planner is the difference that is $2,150,000. This is only the monetary gain because the prevention of a family conflict is priceless. How much do you think the financial planner should charge the client for giving the sound advice worth at least $2,150,000 in value?

On the other hand, John's two advisers earned at least $30,000 in commissions but gave worthless advice.

Before I conclude, the reader may think that financial planning is only for the rich. Actually, the poor are the ones who urgently need the services of a competent planner as they have no room for any mistakes or miscalculation. ■

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