

Submitted to:

Inquiry into Financial Products and Services in Australia

Committee Secretary, Parliamentary Joint Committee on Corporations and Financial Services

Department of the Senate

PO Box 6100 Parliament House

Canberra ACT 2600

By email to corporations.joint@aph.gov.au

Submitted by:

John Robert Markwell

Two copies submitted; .pdf and Microsoft Word formats

Amended 3-AUG-2009

OVERVIEW

This submission is made on an individual basis and opinions expressed are the author's.

I have considerable investing experience and have made a transition from a complete dependency on financial planners while I was an overworked executive director in the entertainment and telecommunications sectors, to almost complete self-reliance at both the planning and investment execution levels. At present I am a trustee of three self managed superannuation funds and trade various instruments on my own account.

In making this submission I will attempt to cross reference my points to the terms of reference by indicating the relevant sentence in the terms of reference as "<n>" where 'n' is the terms of reference sentence number.

Terms of Reference

1. the role of financial advisers;
2. the general regulatory environment for these products and services;
3. the role played by commission arrangements relating to product sales and advice, including the potential for conflicts of interest, the need for appropriate disclosure, and remuneration models for financial advisers;
4. the role played by marketing and advertising campaigns;
5. the adequacy of licensing arrangements for those who sold the products and services;
6. the appropriateness of information and advice provided to consumers considering investing in those products and services, and how the interests of consumers can best be served;
7. consumer education and understanding of these financial products and services;
8. the adequacy of professional indemnity insurance arrangements for those who sold the products and services, and the impact on consumers; and
9. the need for any legislative or regulatory change.

The Role of Financial Planners. <1>

I have no doubt that Financial Planners have a significant role to play in our increasingly sophisticated and increasingly regulated society. Many individuals are financially illiterate and/or too time poor to develop the skills to handle their financial affairs in an effective manner. The collective competency of financial planning, implementation and on-going management across all citizens makes a significant impact on overall national wealth and therefore indirectly plays out in the global arena.

The financial services industry is jam packed with specialists and like the medical services they speak their own language. In financial services, unlike the health sector, the rate of change in both products and services and associated legislation is rapid and relentless. Service provision is market driven, competitive, and some would say ruthless. So how might the average person get a fair deal in such an environment?

I suggest that the role of the financial planner should be very much analogous to that of your medical GP.

I.e. The role of your financial planner ("FP") is to be the general practitioner of your financial good health. It should be a fee based service, just like your GP. There many analogies which could be drawn with health care service provision.

e.g. - the client could have some recourse in the event of professional malpractice.

- there is an educational component in terms of advice and guidance, and so on.

If the role of a FP is perceived to be sufficiently important, and the fees are out of reach for some people, then maybe a basic level of FP service access could be provided by some agency set up for that purpose; something along the lines of legal aid.

Commission arrangements and remuneration models <3>

It has been said that markets are driven by greed and fear. Recent outcomes tend to indicate that the greed factor was certainly not balanced by any fear factor. One viewpoint I read recently:-

"..the system of Western democratic capitalism, which never foresaw that in a society governed passively by free markets and free elections, organized greed always defeats disorganized democracy"

(Quote from http://www.rollingstone.com/politics/story/29127316/the_area_)

I remain hopeful that matters can be indeed improved by better regulation <9> which targets risk/return and benchmarked reporting standards <6>

However, in the recent high publicity cases, detrimental financial planning recommendations have been made with impunity and the commissions certainly were not outcomes based.

Despite regulatory improvements over the years, commission structures can remain almost totally obscure.

In one managed fund Product Disclosure Statement ("PDS") I read, the usual disclosure requirements were there but only for the top level of the overall structure. However, this fund invested in other funds and the full picture became murky as commissions were possibly flowing via administration expenses and it was unclear how much involvement the management had in the lower level funds. I phoned the company marketing the product and asked what the overheads were from top to bottom, from my investment in the fund down to the instruments traded on an exchange. They had no immediate or accurate figures for this but advised that they would find out and call me back. Two days later I was quite surprised that a) they called back, and b) the figure was estimated to be about 6% or over double the indication in the PDS. That is a serious drag on the performance of the fund.

Another personal experience was with a direct to recommended broker allocation of funds within a personal bond structure. The broker managed component lost money while the major market index was advancing. Some years later, when my investment knowledge had improved, I think that the account had been 'churned' by the broker and I suspected that there was an arrangement for kick-back of commissions to the financial planner. When I confronted the financial planner about the poor performance he arranged some discussion with the broker who was somewhat apologetic and offered to reverse some of the transactions to mitigate my loss.

Recommendation: For structured products, managed funds, leveraged arrangements etc. <9> Implement a compulsory investment performance reporting mechanism, annual and monthly/quarterly on-demand, in a plain English prescribed/structured format. If such a fixed format

disclosure is made, most customers will probably attempt to understand what all means <7>. The aim is to highlight risk, return, and overheads along standard business lines.

Information to be provided (where applicable) to include:-

- Compulsory disclosure of commissions and fee structures top to bottom. Amounts, frequency, triggers, and sources, with a standardized estimate for a 1 year hold.
- Portfolio turnover % for instruments traded within a product
- Accumulation / distribution / DRIP attributes of holding.
- Leverage ratio; interest rate for the leveraged component
- Hedging details
- Performance benchmark and performance against the benchmark in various timeframes out to 5 years; after fees and commissions
- Performance of product compared to competitive or similarly classified products, e.g. Quartile % ranking over various time frames.
- Relevance of the benchmark
(some products use inappropriate (low) benchmarks in order for the managers to benefit from performance fees. e.g. interest rates for equities performance benchmark; non-accumulation index for an accumulation fund; an ASX index for a fund invested elsewhere)
- Customer's investment performance and period of investment in the case of partial benchmarking periods.
e.g. from Platinum Asset Management
- | Investor, Fund and Benchmark Performance | Class | Month | Quarter | Year | Inception(pa) |
|---|-------|-------|---------|-------|---------------|
| Investor | C | 1.3% | 19.0% | 10.3% | 11.1% |
| Fund | | 1.3% | 19.0% | 10.3% | 12.0% |
| MSCI All Country Asia ex Japan Net Index in A\$ | | -1.5% | 15.9% | -2.7% | 5.7% |
- Risk *Star rating against a standard template of definitions. (e.g. 1 to 5 Stars range)
- APIR or other standard instrument code to be clearly identified
- Fund size (Capital, number of holders)
- Diversification *Star rating e.g. an ASX200 index tracker would rank more highly than a single sector fund. Determine standard definitions.
- Net Tangible Asset backing for unit / market prices
- Bid – Offer spreads (if applicable)

For each portfolio a higher level statement along similar lines could be constructed.

For the client's funds under advice of a Financial Planner a top level standard format consolidated assessment could be mandated <9>. Non-financial accounting such as the above could be seen as too difficult by many. However, top level metrics are always possible in any management environment once the guidelines are established. Reasonable estimates can be made, with appropriate caveats applied if necessary, as Financial Planners are supposedly competent to understand and handle such matters.

Ratings agencies – a major cog in the marketing machinery.

My SMSF lost money invested in the Basis Yield Fund which collapsed when the CDO market essentially stopped trading. Had I not implemented and followed my fund's diversification guidelines, it would have been a disaster. The guideline was no more than 10% of portfolio with any individual fund or fund management group. In the case of Australian equities with a broker, the diversification rule is applied to any particular market sector (e.g. Resources, Consumer Durables) CHESS holdings provide consumers with isolation from broker failures, except in the case of non-superfund leveraged or otherwise encumbered accounts.

At the time I invested in Basis, I was in the process of taking over from my (ex-) financial planner. I asked him about the fund and was advised that it was OK although he had not included it in any investment 'menu'. I believe the reason for this was the lack of financial planner commissions involved. At this stage I had determined that a high yield fund that the FP previously advised had an exorbitant 3+% trailing commission which completely distorted the risk/return profile. Before investing in the Basis fund, I spent a lot of time doing due diligence as best I could. I met a representative who explained the workings of CDOs and showed me the underlying instruments held by the fund. The CDOs were commercial and not housing mortgage based, but with hindsight this was no consolation as the contagion spread across the entire market and triggered a general market failure.

The degree of leverage employed by Basis was not explained by the representative. The leverage factor became a major problem once the market for the underlying instruments became illiquid. The quality of internal risk management and other control processes of funds managers is very difficult to assess and this is where investors have to rely on third party assessments and ratings for guidance. The Basis Yield Fund was rated as top quality (5 Star) by Morningstar. All tests passed, all boxes checked and industry awards to boot. Within the fund, individual CDO's were rated by the major agencies, mostly they were not top tier 'A' class ratings.

I am now very sceptical about any rating agency and any rating given. In the case of Aegis, my understanding is that investment management companies pay to be rated and then use the results in their advertising campaigns. 'Industry Awards' also form part of the advertising mix. <4> The whole mechanism is apparently unregulated, industry generated and mostly commission and administrative/management fee funded.

Any good Financial Planner would be aware that a typical low overhead index fund will outperform the majority of managed funds in the same market or sector. There are hundreds of Australian Equities funds on offer, few of which are index funds, and relatively few covering other global markets although Australia represents only a couple of percent of the global markets. One has to suspect that commissions are part of the story. Brokerage, administration, management fees all add to the overhead and the consumer pays for all this with his/her savings. Generally speaking, the consumer does not get the investment product choice that a modern global financial centre should have on offer. Something is amiss.

Consumer education. <7>

This is clearly an enormous challenge. There are some good not-for-profit associations such as Australian Investors Association, the Australian Technical Analysts Association, and others, making a great contribution. However, getting the man on the street to participate is another matter.

Some brokers e.g. CommSec give customers an on-line test before they may trade sophisticated instruments like warrants, or place more complex order types. This helps with consumer education.

The best suggestion that I can make is to turn the ASIC FIDO web site into a better advertised and more popular financial portal for the Australian public, and expand it to provide a structured financial literacy education program with on-line help and on-line forum. With individual accounts and some sort of reward scheme like financial literacy 'points' leading to a certificate(s), it should be possible to both broaden appeal and customize content to the demographics. Web marketing and education experts will be able to find an effective approach.

Improved standardization and structure of product description and reporting to consumers ties in tightly with the potential effectiveness of education. If consumers can learn a standard structure and understand each line item, then they will be better placed to make decisions. An analogy is learning how to 'read' a balance sheet, or the technical description of a laptop or mobile phone.

The National Broadband Network initiative will make the delivery of such education much more efficient and effective.

Regulatory Framework. <2> <9>

From the consumer's perspective, investments have a life-cycle.

- There is the initial selection process followed by the investment
- Next is the on-going management or review
- And finally, there is the exit.

Ideally, the consumer is fully appraised of the full cycle before making any commitments. A typical PDS document does a fair job although they are lengthy documents and it may not take too many of these before the consumer loses interest. A standardized structured summary would help in this regard. Once the FP is in the loop the consumer is usually presented with much more simplified data and depends on the Financial Services guide ... and trust.

If a consolidated standard assessment format for all the funds under advice could be provided under suitable regulation, then risk, return, commissions, benchmarks, and so on could not be easily buried in the underlying detail. Excessive exposure to high risk leveraged situations would be clearly stated as the whole of the funds under advice and any associated collateral would be flagged as high risk.

High risk usually means; can you survive a complete loss of this investment.

A consolidated statement of this type could be the basis for assessing the FP's competence or negligence in the event of an adverse outcome and whether or not any compensation claim could be made. <8>

Periodic on-going management review by the FP could update the top level consolidated statement and report performance against benchmark(s) as market conditions and underlying investments change.

Conclusion

Improved education and improved transparency through standardized risk management and performance reporting are likely to produce better outcomes than ever more complex regulation. Regulatory changes are required to either eliminate or expose all commissions and to simplify and standardize reporting through the whole investment life-cycle.

-----END-----