

What went wrong at Storm, and how can we fix it

By Peter Worcester and Paul Resnik

Countless lives have been ruined by the double gearing that Storm encouraged for its clients. Storm and its advisors failed every one of the three main requirements about giving suitable advice. What was their compliance manager doing?

According to the corporations Act 2001, to give suitable advice, you must:

- a) know your client—determine the relevant personal circumstances in relation to giving the advice and make reasonable inquiries about those personal circumstances;
- b) know your product—having regard to information you obtain from the member about their personal circumstances, consider and conduct investigation of the subject matter of the advice as is reasonable in all of the circumstances; and
- c) ensure your advice is appropriate to the member, having regard to your consideration and investigation of the subject matter of the advice (s945A(1)).

1. Know your Client

It would appear that Storm Financial has no knowledge of their individual clients. It appears that it was one size fits all, when it came to double gearing into the Colonial Index Fund. If Storm Financial did have individual knowledge about individual clients, it must have been ignored in order for Storm Financial to generate a “one size fits all” template.

2. Know Your Product

Storm Financial had a standard product of margin lending, with the initial deposit being provided by a home equity release loan.

Let’s consider the margin loan that invests into an Index Portfolio comprising the S&P ASX 200 Accumulation Index. In **Appendix 1** (attached), we have set out our analysis of Margin Lending from January 1981.

The numerical conclusions of Appendix 1 are as follows:

The average after-tax results were:

	Monthly % per month	Yearly % per annum
ASX 200 Accumulation Index	0.70	8.76
Margin Loan Cost (Monthly)	0.62	7.63
Profit from Margin Lending	+0.08	+1.13

These numbers show that over the last 28 years, top marginal tax payers had only a 23% chance of making reasonable money from margin lending. That is not investing – that is gambling.

The research undertaken in Appendix 1 is not difficult. Storm Financial would have had far greater resources to undertake this analysis than the authors of this submission. We can only conclude that Storm Financial did not know their product. Or perhaps they thought that the bull market in equities would never end.

3. Ensure your advice is appropriate to the member

In order to ensure that the advice is appropriate to the member, we need to ensure that the client understands the risks of an investment, particularly in a “Black Swan” event which tends to occur every 10-15 years.

“Before the discovery of Australia, people in the Old World were convinced that *all* swans were white, an unassailable belief as it seemed completely confirmed by empirical evidence.” *Nassim Nicholas Taleb THE BLACK SWAN 2007.*

A Black Swan is something we thought could not exist. A Black Swan event is something we think cannot happen! There is much discussion at the moment as to whether the Global Financial Crisis was a Black Swan Event. The author Taleb describes a Black Swan Event as something we should be surprised about, that has enormous consequences and that we can rationalise later with the benefit of hindsight.

Our view is that similar circumstances can result in one individual describing their experience in the Global Financial Crisis as a Black Swan Event while another will more or less take it in their stride. This we argue is because the latter is better prepared; they understand what is possible and the range of consequences compared to the former.

Extreme Market Behaviour

In **Appendix 2** (attached), we have set out some past examples of extreme market behaviour, and the market dislocations that occur under such stress. When a trauma to the markets occurs, it is almost certain that the following three events will take place:

- Clients panic,
- Institutional Operational Systems fail, and
- Stop Loss systems fail.

The consequences of this level of market dislocation are that it is usually not possible for financial planners to unwind client positions, as there is no liquidity. The client just has to hang on for the ride! These consequences have to be explained to clients before they undertake a leveraged exposure to the equity markets.

Stress Testing of Client Portfolios

We believe that an appropriate way for a financial planner to ensure that a (gearing) investment strategy is appropriate is to apply a stress test to both:

- The client’s assets and liabilities, including their home, and home mortgage, and
- The client’s income and expenditure, both at the consumption level (salary and living expenses, including mortgage payments) and at the investment portfolio level (dividend income and margin loan costs).

We have provided an example of this stress testing in Appendix 3.

Conclusions

1. Anybody who is recommended gearing as part of their financial plan without stress testing of both their balance sheet and revenue & expenditure is being grossly misled.
2. We believe that such stress testing is a fundamental requirement of a proper financial plan, regardless of whether or not gearing is part of that financial plan.
3. Margin lending with Australian shares as an investment strategy is gambling.
4. Double gearing we argue is immoral and probably fails to meet the adviser's duty of care obligations.

Our Recommendations

Our recommendations with regards to the shortcomings of the Storm Financial businesses practices comprise 3 areas:

A. Margin Lending

We do not believe that margin lending) to invest in equities (in its current guise is an appropriate investment strategy for investors who are not “sophisticated or professional investors”.

We recommend that margin lending for retail investors only be available if:

- a. The financial planner is licensed to provide advice on margin lending,
- b. A condition of this licensing is for the client to be given some generic education on the past (long term) returns from margin lending (in line with our Appendix 1),
- c. The client is provided with a proper stress test of their geared portfolio (in line with our Appendix 3), and
- d. The provider of the margin loan for retail investors **has to guarantee liquidity** for the retail client on the securities used for the margin lending portfolio **at the price that the margin lender has previously undertaken to implement his Loan to Valuation Ratio (LVR)**. This guarantee must be of a form that is satisfactory to both APRA and ASIC.

The rationale for this last point is that it removes the liquidity risk, and the “market gapping” risk from retail investors, as set out in our Appendix 2. We do not believe that retail investors will ever fully appreciate these issues, and therefore they should not be exposed to these risks.

We fully acknowledge that this may increase the costs of a margin loan. If so, it is a small price to pay for some protection for retail investors.

B. Compliance of Financial Plans for Retail Clients

It is a requirement of the Corporations Act 2001 that providers of financial services have a compliance program in place to ensure that they and their licensed representatives comply with the Act. It could be concluded from the Storm Financial saga that this was not effective.

This situation could have arisen because of either pressure brought to bear on the compliance manager, or the compliance manager was out of their depth.

We therefore recommend that **the external auditor of a firm holding a financial services license be obliged to audit a number of financial plans for retail clients, to ensure that they are balanced and reasonable.**

C. Enforcement concerning Breaches of the Corporations Act 2001

We believe that retail investors are consumers. Given the past track record of ASIC in this area, we recommend that enforcement activities be transferred to the ACCC.

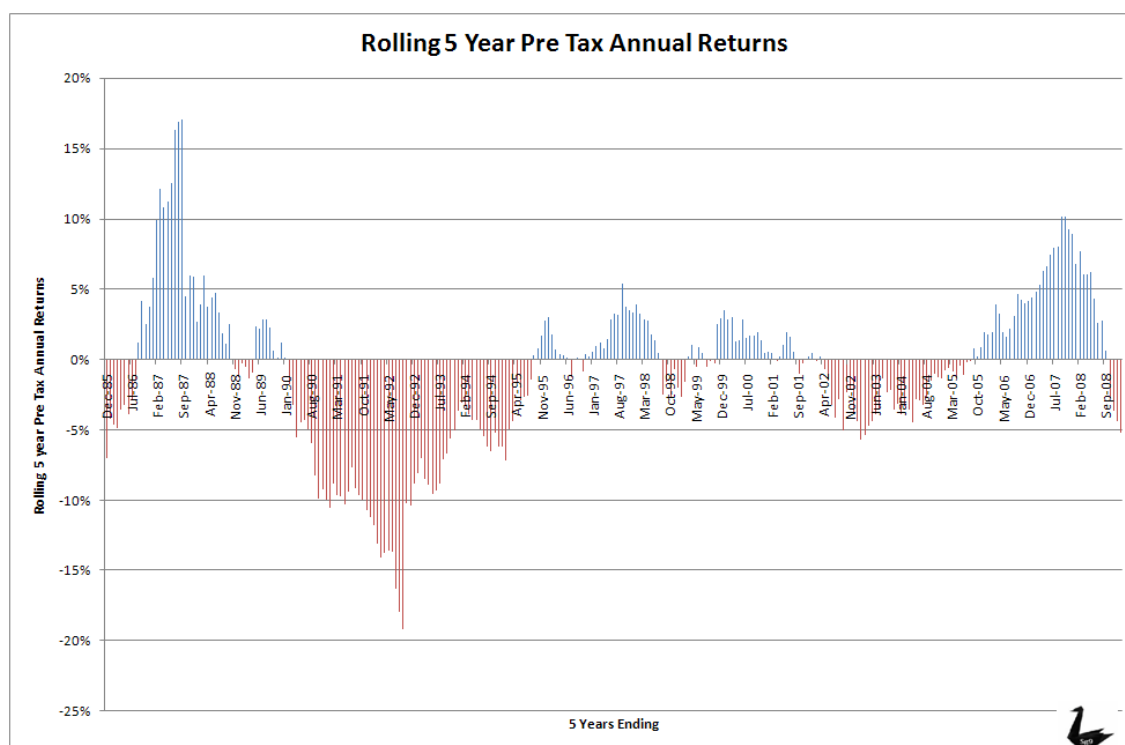
Appendix 1

Margin Lending Does Not Generate Sufficient Returns for the Associated Risks.

We investigated the potential returns for margin lending for the 28 years from January 1981 to December 2008. This period covered both bull and bear markets. Let's summarise the inputs:

- As the results are based on the **Accumulation Index**, dividends are included.
- Cost of borrowing is 5% per annum (payable monthly) over the Bank Bill rate.
- We have assumed no annual costs of investment in the Accumulation Index.
- We have assumed no brokerage costs when purchasing or selling shares.
- We used the data for the **S&P ASX 200 Accumulation Index (All Ordinaries Index prior to 1992)** and the **UBS WDR Australian Bank Bill Index** from 31 December 1980 to 31 January 2009.

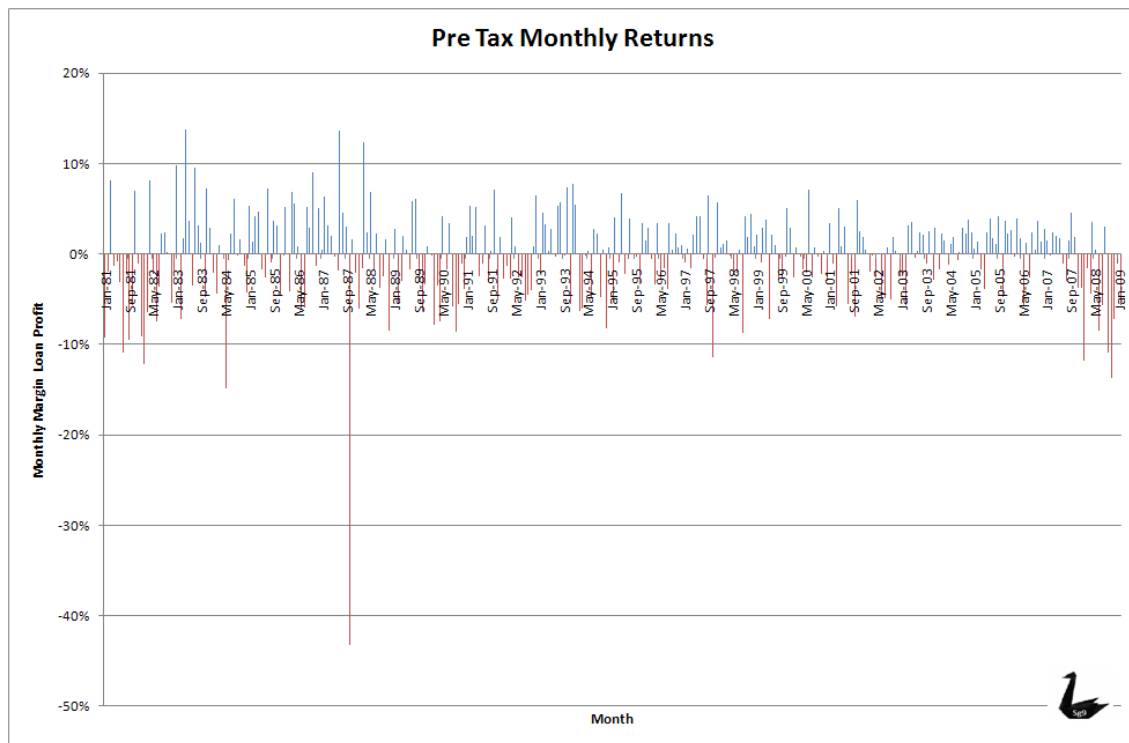
From this data we derived the monthly returns from the share-market, and the base rate for the cost of funds for a margin loan. (Margin loans are usually charged at a cost of around 5% over the bank bill rate). We looked to rolling 5 years annualised returns to give us a reasonable view of the outcomes:



Our initial conclusions were that you would have needed to be a good market timer [and probably a better than average fund manager and fund selector] to make money out of margin lending. The average results were:

	Monthly % per month	Yearly % per annum
ASX 200 Accumulation Index	0.96	12.14
Margin Loan Cost (Monthly)	1.17	14.50
Profit from Margin Lending	-0.21	-2.36

Let's have a look at the pre-tax returns on a month by month basis:

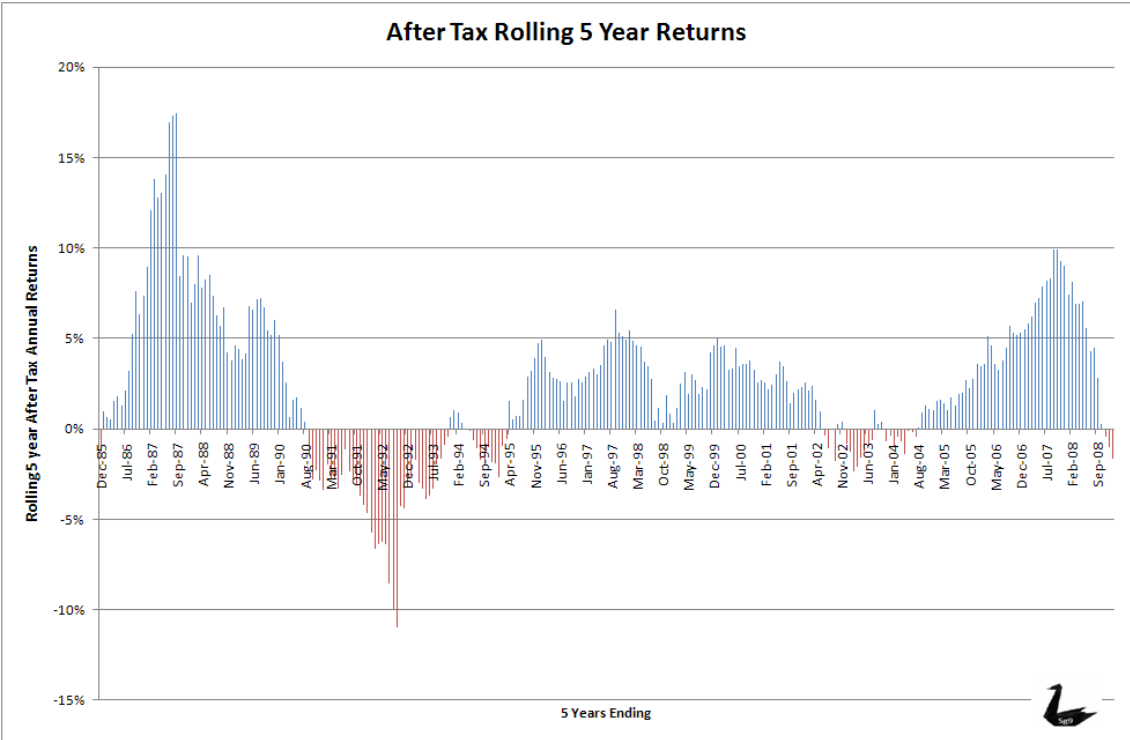


The results:

- Out of 337 months of data, positive returns occurred in 177 months or 53% of the time
- Out of 337 months of data, negative returns occurred in 160 months or 47% of the time
- **The average monthly return over 337 months was negative 0.21% per month, or negative 2.36% per annum**
- The worst month would have been October 1987 where the investment would have lost 43%

After-tax returns were not much better. We modelled for a top marginal tax rate payer, using the following additional assumptions:

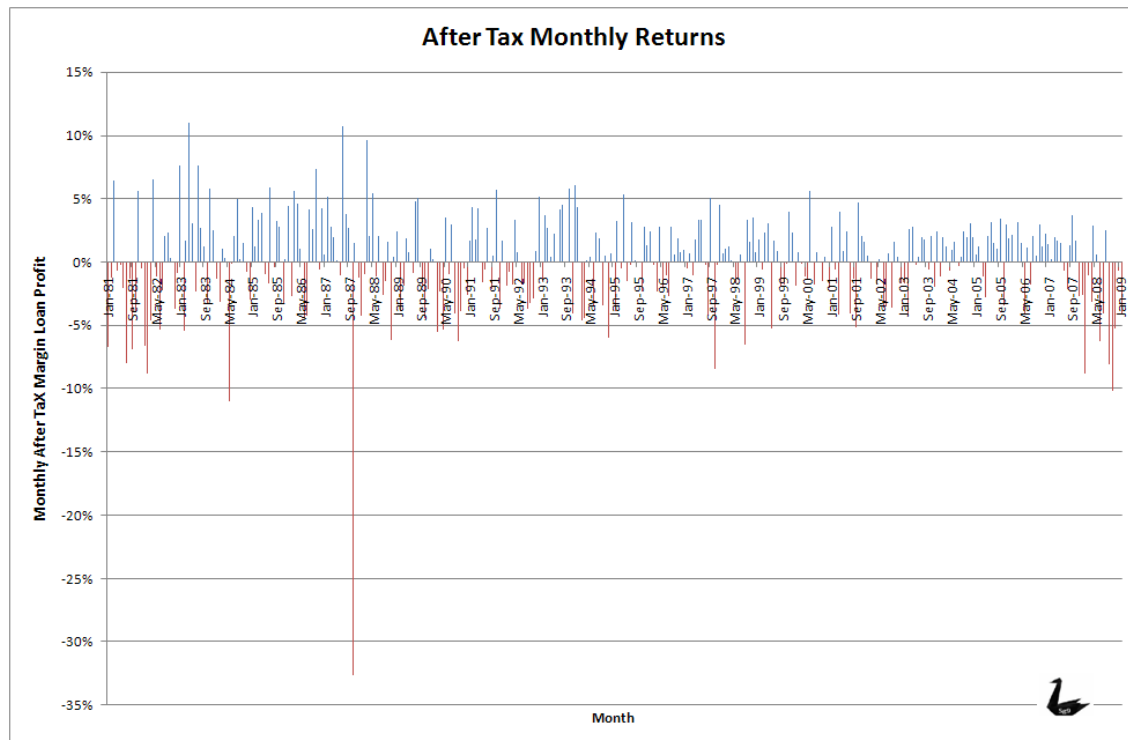
- 70% of dividends are franked,
- Dividend Rate is 5% p.a.
- Corporate Tax Rate is 30%,
- Individual marginal tax rate is 46.5% for income, and 24% for capital gains, and
- No deferral of taxation liabilities for tax.



The average after-tax results were:

	Monthly % per month	Yearly % per annum
ASX 200 Accumulation Index	0.70	8.76
Margin Loan Cost (Monthly)	0.62	7.63
Profit from Margin Lending	+0.08	+1.13

Let's have a look at the after-tax returns on a month by month basis:



The results:

- Out of 337 months of data, positive returns occurred in 185 months or 55% of the time
- Out of 337 months of data, negative returns occurred in 152 months or 45% of the time.
- **The average monthly return over 337 months was positive 0.08% per month, or positive 1.13% per annum.**
- The worst month would have been October 1987 where the investment would have lost 33% after tax. This assumes that the investor would have already had realised capital gains since 1 July 1987 against which to offset the losses of October 1987.

These numbers show that over the last 28 years top marginal tax payers had only a 23% chance of making reasonable money from margin lending. That is not investing – that is gambling.

What do we mean by reasonable? To compensate for the risks being taken, we believe that a margin lending program should return a minimum of 5% after-tax p.a. That is \$5,000 each year for every \$100,000 borrowed and at risk in the market. But, over the last 28 years, only 23% of rolling five year periods produced that outcome – the rest fail to achieve this benchmark.

Investors' suffer when the full story is not told:

- They take on risks that they do not understand and are not suited to. In fact, we doubt that many ever had their risk tolerance properly assessed before being saddled with their margined portfolio;
- They receive margin calls, they lose some of, or all of their portfolio, and in the worst cases they have to sell their homes. Their lives and future plans devastated; and
- Some, gutted by their mistakes, will fight with spouses, suffer depression, divorce or even in the most devastating of consequences take their own lives.

The human misery and tragedy arising from margin lending is very, very real. And it is not covered in neither the margin lender's glossy brochure, nor the simplistic illustrations which are often the only 'education' the investor and planner is given.

Conclusions

We think it is reasonable to expect rolling 5 years returns of at least 5% after tax to compensate for the risks of using a margin loan to purchase shares. But our data shows this outcome is not even close to being achieved on a regular basis in one of the best bull market runs in history.

Margin lending looks to be a gambler's strategy. As a less than 1 in 4 shot of success, it cannot be considered an investment strategy.

We would argue that the vast majority of investors are not natural margin lending clients. Our understanding of financial risk tolerance suggests that the majority of investors would be naturally more comfortable with a more balanced portfolio.

At the very least before taking on a margin loan they *must* have the risks properly explained to them so that they can actively and consciously decide to take on those risks. Going forward this would be a minimum obligation for both direct and advised margin lending clients.

It's time for the education of the benefits and risks of margin lending to be independently delivered.

Appendix 2

What Happens when Markets Fail?

Students of investment market history know that extreme market behavior happens about once every ten years. Going back to 1970, there have been 4 falls in the Australian Equity market that exceeded 30%.

Depth of Fall	Start of Fall
-53.6%	November 2007
-51.9%	February 1973
-43.5%	October 1987
-33.4%	December 1980

The Global Financial Crisis rates the highest in terms of depth of fall, but very similar to the size of the fall from 1973. We suspect that many advisers do not consider such occurrences in putting together geared client portfolios. Communication of down side risk, if explored at all, focuses on nothing more than two standard deviation variations of historical returns.

The 1987 fall was very sharp, with an initial fall of 25% on one day, 20 October 1987. At the other extreme, the fall of 2007-08 was like a slow moving train wreck, the biggest fall being 26% over the three months from September to November 2008.

In 1987, everyone understood that the rules had changed, and where the rubbish was held (Bond, Skase etc.) This was a quick landing. In 2007-08, when the Black Swan hove into view, people also knew what the issue was. It was sub-prime mortgages that had been packaged up into CDO securities. However, nobody could ascertain the size of the problem, or more importantly, which institutions held these securities on their balance sheets. Hence the slow moving crash.

When a trauma to the markets occur, it is almost certain that the following three events will take place:

1. Clients panic,
2. Institutional Operational Systems fail, and
3. Stop Loss systems fail.

Client Panic

We remember 20 October 1987 clearly. Wall Street had a huge fall the previous night, and our share market opened down some 20%. Clients panicked, fearful of losing much of their recent gains. The market had gone up close to 50% since January 1 alone. Clients rang their brokers, instructing them to sell. Telephone systems clogged, and fax machines melted. You could feel panic set in as clients invaded the lobbies of their stockbrokers, fund managers and financial planners. Few knew what advice to give, as the depth and type of fall had not been experienced before. The vast majority of investors had only been in the market for a short while. Many were introduced to equity markets through managed funds which had arrived in the market only after 1980.

All that many could think of doing was sell, which put more downward pressure on the market. Fund managers were forced sellers of their better, more liquid shares, as they had to meet client redemption requests.

Institutional Operational Systems Fail in a Panic

When subject to a large market movement you have to expect operational failures. Some will say that this shouldn't [be allowed to] happen; this view is of course naïve. An analogy is the recent Black Saturday bushfires that killed 173 people in Victoria. Many will argue that we should have had more fire crews, but there can never have enough fire personnel for the intensity of a Black Saturday.

An example of failure in operational systems in late 2008 was with margin calls. Consider this scenario:

- Market falls 20%
- Margin Loan lender makes margin call to Wrap Account
- Wrap Account calls dealer and financial planner
- Financial planner calls client
- Client decides to inject more cash, or more likely, sell down the portfolio.

This scenario can (and generally does) work efficiently in normal times, but what happens when the sheer volume of margin calls overwhelm the participants? What happens when the financial planner is away at a compliance workshop? What happens when the client is on holidays? What happens when the client doesn't understand what a margin call is?

Margin lenders are often reluctant to immediately sell down client portfolios, without the client themselves having at least 24 hours to consider their position. Combine this with systems overloads at the margin lenders office, and as a result margin calls can take weeks to be executed. By then, the portfolio may have fallen another 10-20%, and the client is in even greater financial difficulties.

Stop Loss Systems Fail.

Many clients and some advisors believe (did believe?) that a “stop-loss” system can be put in place to limit downside losses in a client’s portfolio during a market fall.

An example of such a process might be: “Sell all of my portfolio should the market fall by 10%.” This sounds quite reasonable, as the client and his planner might feel that the maximum losses to the client will be 10%, an amount that the clients feels comfortable with, taking into account his/her tolerance for risk and risk capacity.

However, Stop Loss systems can fail due to a combination of:

- Market Pricing gapping, and
- Lack of Liquidity.

Markets can “gap” such as on 20 October 1987, when the market opened 20% lower than its closing position at the end of the previous day. Clearly, executing a stop-loss plan to limit losses to 10% would have been impossible then.

Furthermore, when there is a significant fall in the markets, liquidity evaporates on the buying side. This means that there is nobody ready to buy the stocks you wish to sell in order to satisfactorily execute your stop loss strategy.

When markets fail, as they surely will, you and your clients will have to hang on tight, and keep riding the portfolio downwards. History shows us we have no viable alternatives.

If an investor is aged 45, there is a reasonable chance they will experience about 3 or more significant market corrections in their lifetime. Can they survive these crashes?

Appendix 3

Proper Financial Planning – Stress Testing

Consider a client with an asset/liability portfolio as follows:

Assets		Liabilities	
House	\$ 1,000,000	Mortgage	\$ 400,000
Superannuation			
Shares	\$ 300,000		
Property	\$ 50,000		
Fixed Interest	\$ 100,000		
Cash	\$ 50,000		
	\$ 500,000		
	\$ 1,500,000		\$ 400,000
Less Liabilities	-\$ 400,000		
Net Worth	\$ 1,100,000		

Let us now make an estimate of their income and expenditure:

Income		Expenditure	
Salary 1	\$ 170,000	Tax 1	\$ 56,550
Salary 2	\$ 50,000	Tax 2	\$ 9,350
		Health Insurance	\$ 3,000
		Life Insurance	\$ 2,000
		Income Protection Insurance	\$ 3,000
		Mortgage Payments	\$ 33,700
		School Fees Child 1	\$ 19,000
		School Fees Child 2	\$ 15,000
		Car Repayments (\$50,000 Car)	\$ 14,800
		Gas, Fuel, Phone	\$ 2,500
		Council & Water Rates	\$ 1,500
		Food	\$ 15,000
		Clothes	\$ 10,000
		Medical/Chemist	\$ 2,000
		Holidays	\$ 15,000
		Entertainment	\$ 10,000
Totals	\$ 220,000		\$ 212,400
Surplus	\$ 7,600		

This shows a surplus of \$7,600 p.a. after tax.

Let us now consider the double gearing scenario in which:

- The house mortgage is increased by \$300,000,
- This \$300,000 is used to secure a margin loan of \$600,000, and
- The \$900,000 is invested in an index share portfolio.

The balance sheet of the client shows an increase in assets of \$900,000 (index share portfolio), together with an additional \$900,000 of debt. However, the client's net asset position remains at \$1,100,000.

Assets		Liabilities	
	Home	\$ 1,000,000	House Mortgage \$ 700,000
Superannuation			Margin Loan Facility \$ 600,000
	Shares	\$ 300,000	
	Property Securities	\$ 50,000	
	Fixed Interest	\$ 100,000	
	Cash	\$ 50,000	
		\$ 500,000	
Non Super Share Portfolio		\$ 900,000	
TOTAL ASSETS		\$ 2,400,000	Total Liabilities \$ 1,300,000
Less Liabilities		-\$1,300,000	
NET ASSETS		\$ 1,100,000	

We know from Appendix 1 (above) that negative gearing from a margin loan will create a profit of about 1% p.a. after tax. However, this includes the capital gains (after tax). If we leave out the capital gain, then the margin loan will produce negative cash flow of about 4% after tax, allowing for dividend income and franking credits.

The extra housing loan of \$300,000 used to purchase shares (assume interest only loan) will produce negative cash flow of about 2.5% after tax, allow for dividend income and franking credits.

Hence our cash flow shortage as a result of the double gearing proposal is 2.5% of \$300,000 plus 4% of \$600,000, totalling \$31,500 per annum after tax.

This means that our client will have to cut out some living costs to fund this double gearing plan, or hope to take regular capital gains to fund the \$23,000 annual after tax shortfall. The double gearing plan is already on thin ice.

Alternatively, the client could capitalise the interest shortfall via additional loans.

Let us now stress test this portfolio. How do we stress test this portfolio? There are many ways, many of which may be appropriate. We believe however, that if a financial planner is to properly involve their client in the portfolio construction and its stress testing, then the simplest practical approach is best.

In order to stress test the client's portfolio, we need to make some assumptions about the extent of a possible market fall, or the size of the Black Swan. We think the assumptions below make a good starting point.

Asset Class	Size of Black Swan Fall
Shares	30%
Property Securities	20%
Fixed Interest	10%
Cash	nil
Residential Property	10%

These falls, while being large, have been exceeded in about 4 market collapses since 1975. In the table below, we have reduced the value of each asset group by the amount of the "Black Swan Fall":

Assets		Black Swan Fall	Black Swan Value	Liabilities	
Home	\$ 1,000,000	10%	\$ 900,000	House Mortgage	\$ 700,000
Superannuation				Margin Loan Facility	\$ 600,000
Shares	\$ 300,000	30%	\$ 210,000		
Property Securities	\$ 50,000	20%	\$ 40,000		
Fixed Interest	\$ 100,000	10%	\$ 90,000		
Cash	\$ 50,000	0%	\$ 50,000		
	\$ 500,000		\$ 390,000		
Non Super Share Portfolio	\$ 900,000	30%	\$ 630,000		
TOTAL ASSETS	\$ 2,400,000		\$ 1,920,000	Total Liabilities	\$ 1,300,000
Less Liabilities	-\$ 1,300,000		-\$ 1,300,000		
NET ASSETS	\$ 1,100,000		\$ 620,000		

As a result of these fall, the "Perfect Storm" is looking really ugly. The investor has lost 44% of their net worth, or \$480,000. The LVR on the margin loan is now 95%. In order to get the LVR on the margin loan back to 67%, they will have to sell \$540,000 of shares "at the bottom" of the market.

The client's position ends up as follows after the margin call:

Assets		Liabilities	
Home	\$ 900,000	Mortgage	\$ 700,000
Superannuation		Margin Loan	\$ 60,000
Shares	\$ 210,000		
Property Securities	\$ 40,000		
Fixed Interest	\$ 90,000		
Cash	\$ 50,000		
	\$ 390,000		
Non Super Share Portfolio	\$ 90,000		
TOTAL ASSETS	\$ 1,380,000	Total Liabilities	\$ 760,000
Less Liabilities	-\$ 760,000		
NET ASSETS	\$ 620,000		

Let us also cease all margin loan activity, and apply the net (non-super) share portfolio to reducing the mortgage by \$30,000 after selling the \$90,000 in shares and paying off the margin loan.

Assets		Liabilities	
Home	\$ 900,000	House Mortgage	\$ 670,000
Superannuation			
Shares	\$ 210,000		
Property Securities	\$ 40,000		
Fixed Interest	\$ 90,000		
Cash	\$ 50,000		
	\$ 390,000		
TOTAL ASSETS	\$ 1,290,000	Total Liabilities	\$ 670,000
Less Liabilities	-\$ 670,000		
NET ASSETS	\$ 620,000		

Let us now revisit the estimate of their income and expenditure. Convert the interest only part of the mortgage to credit foncier, or principal & interest. The yearly mortgage payment goes up from \$33,700 to \$56,500.

Income		Expenditure	
Salary 1	\$ 170,000	Tax 1	\$ 56,550
Salary 2	\$ 50,000	Tax 2	\$ 9,350
		Health Insurance	\$ 3,000
		Life Insurance	\$ 2,000
		Income Protection Insurance	\$ 3,000
		Mortgage Payments	\$ 56,500
		School Fees Child 1	\$ 19,000
		School Fees Child 2	\$ 15,000
		Car Repayments (\$50,000 Car)	\$ 14,800
		Gas, Fuel, Phone	\$ 2,500
		Council & Water Rates	\$ 1,500
		Food	\$ 15,000
		Clothes	\$ 10,000
		Medical/Chemist	\$ 2,000
		Holidays	\$ 15,000
		Entertainment	\$ 10,000
Totals	\$ 220,000		\$ 235,200
		Deficit	\$ 15,200

There go the holidays! The mortgage is up from \$400,000 to \$670,000.

Because the black swan has landed, let us now consider the loss of the second income:

Income		Expenditure	
Salary 1	\$ 170,000	Tax 1	\$ 56,550
		Health Insurance	\$ 3,000
		Life Insurance	\$ 2,000
		Income Protection Insurance	\$ 3,000
		Mortgage Payments	\$ 56,500
		School Fees Child 1	\$ 19,000
		School Fees Child 2	\$ 15,000
		Car Repayments (\$50,000 Car)	\$ 14,800
		Gas, Fuel, Phone	\$ 2,500
		Council & Water Rates	\$ 1,500
		Food	\$ 15,000
		Clothes	\$ 10,000
		Medical/Chemist	\$ 2,000
		Holidays	\$ 15,000
		Entertainment	\$ 10,000
Totals	\$ 170,000		\$ 225,850
		Deficit	\$ 55,850

No more private schools. No more holidays. Imagine the stress this family is under. A possible case of divorce and/or suicide! All because they entered a perfect storm without stress testing both assets and income & expenditure! Black Swans do land. More frequently than you expect!