Australian Investors Association

Submission on the

Inquiry into Financial Products and Services

Investors Helping Investors

As a non-profit organisation, The Australian Investors' Association exists for one purpose: to help our members become more successful long-term investors.

We protect and advance the interests of Australian investors across all types of investments and asset classes – including shares, cash, property and managed funds. Whether you invest through a Self Managed Super Fund, a family trust, or directly, the Australian Investors' Association leads debate on the policies and issues that matter to you.

Together, we can accomplish more. The Australian Investors' Association's local meetings, leading national conference, investor bulletins, tele-presentations and website provide the opportunity for members to connect and learn both from experts and each other's experience.

Regardless of where, why and through what structure you invest, the Australian Investors' Association can help you develop the skills to take ownership of your financial future.

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Mr Bernie Ripoll MP
Chair
Parliamentary Joint Committee on Corporations and Financial Services
Department of the Senate
PO Box 6100
Parliament House
Canberra, ACT, 2600

Dear Mr Ripoll

Please find herewith the Australian Investors' Association (AIA) submission to your committee's Inquiry into Financial Products and Services.

The AIA is a nation wide group of two thousand members devoted to the notion of '*investors helping investors'*. We do this by conducting an extensive program of educational activities, both formal and informal in nature. It is part of our culture, deriving from less than satisfactory experiences in seeking assistance from financial advisers, that we press hard for reform within that industry, starting most crucially with the methods of remuneration.

The AIA has a strong policy against commissions, both as percentages of amounts invested on entry and periodically thereafter (trailing commissions), and against payment as a percentage of funds-under-advice.

We also note with deep regret from time to time, the disasters that befall other investors who place their trust in representatives of the financial services industry, only to end up victims of human greed and incompetence.

It is to these themes that we address this submission.

We congratulate those responsible for establishing this Inquiry and offer our perspective on its antecedents. We acknowledge the difficulty associated with dealing effectively with the problems raised. But having said that we urge the Inquiry to act strongly to ward off future episodes of financial disaster as have befallen numerous Australians in the last couple of years.

The Australian Investors' Association stands ready to assist in any way that it can.

Jolyon Forsyth

President

April 2009

Executive Summary – Key submissions

1. The commissions payment structure inevitably restricts the type of advice given to products from which commissions flow.

2. There are multiple levels of fees and charges within financial products and the significance of these should not be under-estimated.

3. There is an opportunity for Government and regulators to partner with community organisations that might be more alert to potential financial disasters for consumers.

4. It is imperative for people to educate themselves prior to making investment decisions, and for them to be more prudent and less submissive in accepting advice about financial matters which they do not understand.

5. There is a culture of 'selling' pervading much of the financial advisory services industry that pretends to be 'professional service providing'. It is crucial that we find a way of separating these two functions.

6. There are unacceptably low educational levels required of financial advisers, particularly those who've long been in the industry, and for whom entry level qualifications were almost non-existent.

Submission 1:	***The commissions payment structure inevitably restricts the type of advice given to products from which commissions flow.***

Consider the case of John and Mary who are middle-aged with a couple of children, a mortgage of $150,000 and school fees totalling $15,000 pa. Their employers are contributing 9% to industrial or company superannuation funds. Unexpectedly they receive an inheritance from a parent of one of them of $150,000. So they visit a financial adviser to ascertain their options.

The following are some of the most commonly accepted options:

1. pay off the mortgage completely
2. pay off part (say $100,000) and contribute (say) $25,000 each to their super funds
3. place the $150,000 in term deposits to pay for the school fees each year (gradually depleting the capital)
4. invest the $150,000 in a portfolio of shares or in a series of managed funds in a master fund
5. pay off the home loan completely and re-borrow (say $100,000) against the equity in their home
6. place the $150,000 in a margin lending facility with another $150,000 provided by the lender, thereby investing $300,000.

Many choices possible, all with good points and some with risk attached. The virtue of each option isn't the point. Rather it is the options that probably won't even be mentioned because there's nothing in it for the adviser who charges by commission. The first three options fall into this category. Most independent advisers would support the first and/or second as key first steps. This reflects the best interests of John and Mary. (They might move on to suggest option five or even six – but the fourth option would be a no-no.) Experience of our members suggests that option four would be the first suggestion of commission-paid advisers. This reflects the best interests not of John and Mary, but of the adviser.

Hence commissions give rise to inherent conflicts of interest.

Let's move on to the implementation of option 5. The home loan has been repaid but John and Mary have re-borrowed $100,000 using equity in the home as collateral. The adviser now has some alternatives for investment:

1. Five managed funds within a master fund – 4% entry commission and 0.5% pa trailing commission ($4,000 now and $500 pa).
2. Three or more separate retail managed funds (same commissions as above).
3. One or two wholesale managed funds (each more than $50,000) – no commissions payable.
4. A portfolio of Australian shares – 1% brokerage at start and whenever buying/selling occurs.

Option three would be the smartest move from the point of view of John and Mary, but not for the adviser.

Many Australians would in fact borrow enough to purchase an investment property. But the adviser probably won't suggest this as commissions are generally not payable in this situation.

Here are more situations in which commissions give rise to inherent conflicts of interest.

Submission 2:	***There are multiple levels of fees and charges within financial products and the significance of these should not be under-estimated.***

Financial institutions package a diversified range of shares and other investments in investment products so that a person with a smaller capital base can more conveniently participate in the local or overseas share markets or property markets. The charges include:

Entry fees that vary but can be up to 7%, but a typical fee would be 4%, of the money contributed to the managed fund. Some (usually most) of this fee is paid to the adviser for the service of arranging the transaction

No Entry fee retail funds may dispense with the entry fee if the money stays in the fund for a certain time but has a higher management fee to compensate for no entry fee.

Trailing Commission is an annual payment to the adviser to pay (allegedly) for the on- going costs of monitoring the investment for the client and can be typically about 0.44% to 0.66% of the value of the investment balance.

A Performance Fee is an extra fee in some funds. If the performance is above a certain level, then the fund manager increases the manager's fee to reward the extra performance.

Buy/Sell Spread Fee is the charge made to buy the actual shares when a new investment is made and to sell them when the investment is redeemed. The normal spread is about 0.5%.

Exit Fees are not so common now but can occur in a case of a nil entry fee fund where the money is not held for a minimum time.

On top of all these fees it is common for the adviser to arrange for the managed funds to be purchased within a master-fund with its own **Platform Fees** that make the administration of the portfolio of funds easier.

There have been many attempts to quantify the effects of these charges on investments over the longer term. For example consider what happens to a $100,000 investment which returns 8%pa over a 10 year period. With an entry commission of 4% and trailing commission of 0.5%pa, this will amount to $198,000 over a ten year period. With no such fees the total will be $216,000. Over longer periods the difference increases dramatically.

Investors should be made aware of this cost over the longer term by adequate and understandable disclosure.

Submission 3:	***There is an opportunity for Government and regulators to partner with community organisations that might be more alert to potential financial disasters for consumers.***

In Australia we have had a long list of financial investment disasters in this last decade: Westpoint, Fincorp, Australian Capital Reserve, Opes Prime, and now Storm Financial.

Often there were early warning signs of collapse, yet investors continued to place money with these firms. We note with disappointment reports of complaints made to ASIC up to several years prior to a number of these disasters, that appear not to have been followed up.

We need an early-warning mechanism that works. There is clearly an important role for agencies both within the government sector (ASIC), the non-government (Australian Consumers Association and our own group), as well as within the industry (Financial Planning Association).

We propose that ASIC establish a Consumer Protection Task Force that draws on the resources from within government, non-government and the financial services industry to monitor and report on investment advisory products and practices that endanger consumers.

Submission 4:	***It is imperative for people to educate themselves prior to making investment decisions, and for them to be more prudent and less submissive in accepting advice about financial matters which they do not understand.***

Consider the case of Fred and June, retired with superannuation accounts of $500,000 and a home they own outright worth $750,000. Fred and June were attracted by the amazing claims made by Storm Financial. It is reported that they borrowed $600,000 using equity in their home, and then placed this in a margin loan with an additional $680,000 of borrowed money. This cost them $128,000 in upfront fees. When the market fell 50% the investment reduced to $560,000, which the bank retrieved by selling the portfolio, leaving the investor with a $600,000 debt on his home. Clearly, living on account-based pensions, they were unable to make loan repayments and had to sell their home to pay off the loans.

Undoubtedly Fred and June wondered from time to time about the risk they were taking. But reassurances by an adviser settled their concerns. They didn't know enough to ask:

1. By how much might the Australian share-market fall?
   Answer: it fell by almost 50% in 1987

2. What affect would that have on us?
   Answer: you'd be bankrupt.

3. How likely is that to happen to us?
   Answer: not very, but it could as it has in the past.

An adviser would not only answer such questions, but would pose them for Fred and June; a salesman would not do the latter, and would skirt around the former.

Submission 5:	***There is a culture of 'selling' pervading much of the financial advisory services industry that pretends to be 'professional service providing'. It is crucial that we find a way of separating these two functions.***

A case based on experiences of other clients of Storm Financial and reported in *Money Management* demonstrates that giving appropriate advice wasn't the driving motivation within that group but rather product selling.

This client was a self-funded retiree who owned not only his own home but four other properties, and had other assets totalling over $300,000. As a direct result of a double gearing strategy this couple are now unemployed, have a $1,500,000 debt after selling all the properties except the family home. Some shares and superannuation remain. But their indebtedness exceeds their assets by some hundreds of thousands of dollars..

The 'selling' was so good that not only was this couple enticed into a regrettable arrangement, but so were the parents of one of them (aged 72 and 68). They now have a debt in excess of $300,000, the pension to live on, and face the prospect also of losing their family home.

It is in our view unarguable that a culture of selling underpinned the financial service being provided in cases such as these. Admittedly these are the extreme examples. But it is clear that at root the fault lies in the remuneration being directly connected with the dollar value of investment being sold to people. Commissions beget salespeople – it's human nature.

We need to find a way of separating the two functions: providing advice and selling investment products. The adviser would be paid for advice just as so many other professionals are – taking account of the complexity of the advice and the time it takes to assemble and present it. Thereafter, if investment products are called for, the client moves on to the salesman (who might well be paid by commission). Alternatively the adviser might well organise the investment products but charge a fee-for-service not commission.

A simple analogy is doctor and chemist. The doctor gives the advice (a prescription) and the chemist supplies the product.

There must be a way of separating the functions of advice-giving and product-selling; this has become such a problem that the solution will only be found by legislation and regulation. The industry itself has been shown to be toothless in confronting this problem.

Submission 6:	***There are unacceptably low educational levels required of financial advisers, particularly those who've long been in the industry, and for whom entry level qualifications were almost non-existent.***

The financial advisory industry developed out of stock-broking and selling of insurance, neither of which have historically had significant educational requirements. Gradually as the industry has developed over the last 20 – 30 years the complexity of the advisory tasks has increased dramatically and educational requirements have risen – but nowhere near enough.

Right now it is possible to work as a financial adviser having completed four subjects of an eight-subject diploma-level course. In that situation the law requires the licensee of the financial advisory business to ensure that such an adviser works only within situations that that level of education provides for. This is hardly confidence boosting for the public.

Over the last 10 years most new entrants have worked to complete the diploma. But what of those who entered years ago as insurance salesmen? Admittedly, to earn the status of Certified Financial Planner (awarded by the Financial Planning Association) requires completion of five post-graduate subjects on top of the diploma. More recently the FPA has raised the bar some more, requiring an appropriate undergraduate degree after which the five post-graduate subjects are taken. In the long term this will prove to be very well worthwhile.

But there remains a very large group who we believe to be very underqualified to give the complex sort of advice needed to survive in the investment markets these days.

Many of our members find if they visit a financial adviser or talk with them incidentally, that they know far more about stock selection and portfolio design than do professionals in the industry.

There is an urgent need to require upgrading of current financial advisers; and to make it clear to clients exactly what an adviser is authorised (being appropriately qualified), to give advice about.