SUBMISSION TO FINANCIAL SYSTEM INQUIRY

SUBMITTED BY:

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About the Submission:

Tony Rumble PhD is a Sydney based asset consultant specializing in training and accreditation for financial advisers. Tony (via the “ASX Listed Products Accreditation Course” (LPAC Online)) has trained 2000 financial advisers specializing in providing advice regarding ASX Listed Investments: the LPAC program was commissioned by ASX in 2003 and is approved by the FPA Australia.

LPAC Online is a training supplier to the ATO.

Dr Rumble was a member of the Panel of Experts to the Australian Government Board of Taxation between 2001 and 2007 and was a consultant to the “Ralph” Review of Business Taxation.

Prior to founding LPAC Online, Dr Rumble was a partner at PricewaterhouseCoopers and head of the firm’s Finance and Treasury Group. Dr Rumble has consulted to the ASX, ATO, Australian Treasury, Australian Government Solicitor, OECD, and has taught at Harvard Law School.

Dr Rumble was a senior lecturer at ATAX UNSW between 1995 and 1998 where he led the ATAX teaching and research in the areas of corporate finance, derivatives and financial products.

Dr Rumble is head of education for the SMSF Owners Alliance.

This submission is in 2 parts:

This part;

And

Annexure: Blending Stock Picking with Index Investing

SMSF GEARING

The Murray FSI interim report has called for scrutiny of SMSF gearing. We do not support a ban on SMSF gearing except in the case of specific forms of SMSF gearing products which we refer to below. Sensible analysis of SMSF gearing must delineate between the benefits of "protected" SMSF loan products, compared to newer, riskier SMSF lending technology which certainly should be under the microscope.

Investment control is the main reason people set up SMSFs. Many buy and hold assets for the long term – the opposite of the high turnover trading of actively managed "benchmark aware" managed funds. The buy and hold approach accesses a growing income stream from rent or dividends, insulating the capital value of the portfolio from the risk of loss that comes with high frequency trading and investment products like traditional managed funds.

SMSF gearing is required by law to be "limited recourse" - it must not allow the lender to recover any losses from the general assets of the borrower. Apart from selling the secured asset to cover any loan default, the lender can't chase the borrower to top up any remaining losses. That can lead to systematic risks to the banking sector and that is why – at least in the case of SMSF lending against shares – loan providers typically embed additional protection mechanisms when they lend to SMSFs.

Properly used these protection mechanisms can actually reduce risk to investors. Consider the case of ASX listed instalment warrants – popular with SMSFs since their inception in 1997 (and disproving the myth that SMSF gearing has only been legal since 2007). In this multi-billion dollar market the instalment warrant issuer charges a slightly higher loan interest rate and uses the excess to buy put options to cover its risk of loss in the event that the instalment loan is not repaid.

ASX listed instalment warrants are financially equivalent to protected equity loans. Financial analysis of protected equity loans shows that despite the higher interest rates charged for them by their providers, the avoidance of capital loss on underlying assets typically means that protected equity loans outperform compared to ungeared/unprotected portfolios – see table 1 below.

The rationale for investor's using gearing to assist with share purchases was favourably commented on by corporate finance scholars Modigliani and Miller in their seminal work on corporate balance sheet structure. That work recognized that the companies into which investors gear, may themselves be under geared—and in this case, external gearing is simply a "self help" investor reaction to this under-gearing:

> "Levered companies can not command a premium over unlevered companies because investors have the opportunity of putting the equivalent leverage into their portfolio directly by borrowing on personal account."[1]

[1] Modigliani F and Miller M: "The Cost of Capital, Corporation Finance and the Theory of Investment" (1958) The American Economic Review 261 at p. 270.

In this context it can be argued investors who gear their holdings do so in a manner consistent with the original Modigliani – Miller view that it may be sensible for investors in relatively under-geared companies to do so. When that happens investors assume the risk of insolvency that the companies over whose shares they gear declined to take on – but using limited recourse finance defeats that risk and rationalizes the use of gearing.

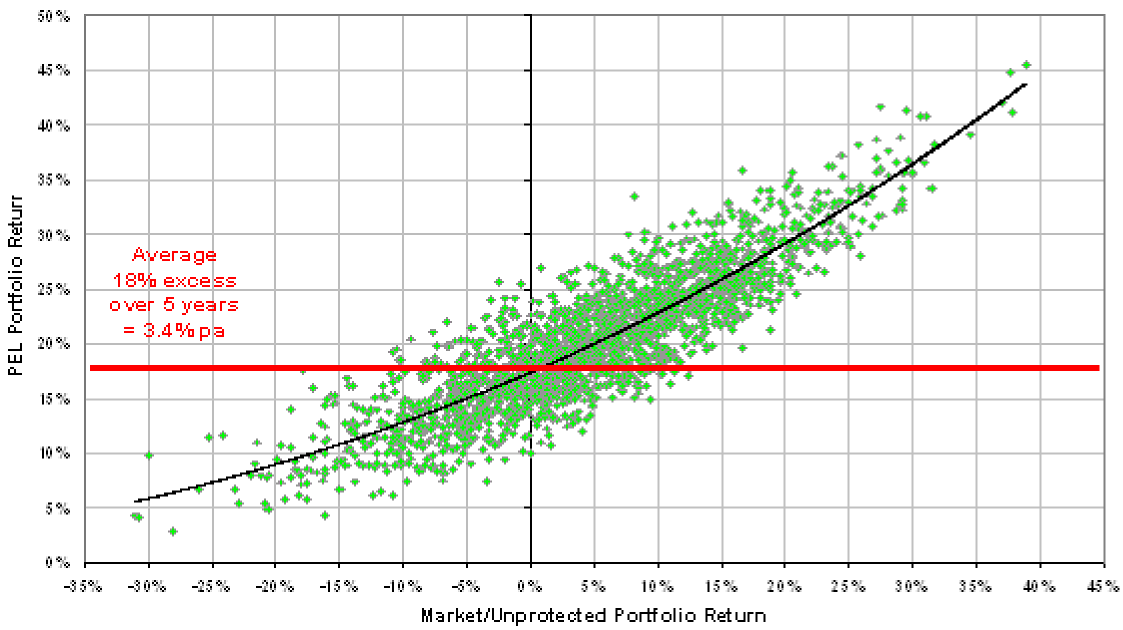

Table 1: Protected loan portfolio performance compared to unprotected portfolio performance. Source: Westpac. In this table each green dot represents a portfolio of shares over which an actual protected equity loan was created, and the returns are actual returns for each portfolio.

In the case of protected equity loans and instalment warrants, because the loan subsides the cost of investment, the investor actually enjoys lower risk than if they purchased the share outright. (Assuming that the investor does not multiply their exposure to the underlying shares using multiple instalment warrants, in which case the investor's risk of loss may equal or exceed the full face value of each share).

Further, as long as annual interest payments are made on the instalment warrant loan, the investor retains total control over the loan and hence controls when and if the underlying share is sold. SMSF property loans work similarly – as long as the loan interest is paid, the lender can never force the sale of the property against the wishes of the SMSF.

Typical instalment warrants capitalize the interest cost such that a "default" in payment of interest is in practice impossible to occur.

This avoids the problem with margin loans where the investor can be forced to sell shares into a falling market, even if loan interest is being paid, when the share prices falls sharply. Being forced to sell in down markets is termed being “short gamma” – and this is the problem which bedevils margin loans, many structured products, and traditional actively managed funds.

That is, instalment warrants are not short gamma – unless they include a stop loss mechanism (see below).

We do recognize that although traditional instalment warrants avoid many of the risks that arise with other forms of gearing, there are some structural concerns that can arise with other forms of SMSF gearing:

1. An investor protection issue does arise with newer forms of SMSF gearing – such as the “stop loss” style of instalment warrant, and the “equity lever” forms of synthetic SMSF gearing. Both products are “short gamma” and behave like margin loans – the product issuer doesn’t use put options to protect their loan, instead selling down shares when the market falls, in order to repay the loan prior to the share price falling below the loan amount.

   We note that Macquarie Bank and National Australia Bank offer a synthetic gearing facility which they argue avoids the scope of the SIS Act – because they state that the gearing is external to the facility. If that truly is the case then it is impossible to understand how any “interest” is paid by the investor – nevertheless these products assert that the investor is indeed paying “interest” and a tax deduction is available for that payment.

   These “equity lever” products seek deliberately to avoid the impost of section 67 A of the SIS Act – which prohibits a gearing facility including more than one “single acquirable asset.” That rule is designed to stop a lender selling down shares or other assets (which haven’t fallen in value) to recover losses on other shares which have fallen in value.

   The single acquirable asset rule is a pro consumer rule and breaches by synthetic gearing products should be outlawed. Stop loss style SMSF gearing should also be outlawed.

2. SMSF gearing is a form of derivative because repayment of the loan is optional. It should be regulated by requiring advisers to have competency to advise on derivatives, and the financial skills to assess the risk of higher break-even costs (because of interest payments) overwhelming the geared investment.

   This highlights two other aspects of concern: the need for better professional education for financial advisers (critically noted by the Murray FSI) and the need for effective policing of the “investment strategy” provisions of the SMSF rules (as yet ignored by the FSI) (as to which, see our comments below).

FINANCIAL ADVISER COMPETENCY

Financial adviser competency is a major concern for all investors and we welcome calls for significant and urgent improvement in this matter.

However we note that the issue requires resolution of the role of critical thinking in education and the need to embed critical thinking in any mandatory curriculum for financial advisers.

The current system of adviser education and licensing is flawed because it does not differentiate between product sales, compared to professional financial advice. We do not suggest that personnel tied to banks or financial institutions should be prevented from selling investment products nor even from earning a fee for doing so. However we do strongly submit that tied personnel should be prohibited from purporting to provide financial advice – and should be noted as performing a sales function only.

We submit that the definition of a tied person would include:

- Any employee of a financial institution which has manufactured an investment product in respect of which a sales recommendation is being made (or any related body thereof, including a dealer group which is owned partly or wholly by that financial institution or related body);

- Any person who receives a fee or other financial benefit from a financial institution which has manufactured an investment product in respect of which a sales recommendation is being made (or any related body thereof, including a dealer group which is owned partly or wholly by that financial institution or related body);

- For these purposes a financial benefit includes any benefit, cost reduction, training or professional education from the financial institution which has manufactured an investment product in respect of which a sales recommendation is being made (or any related body thereof, including a dealer group which is owned partly or wholly by that financial institution or related body)

The need for critical thinking is closely linked to the concept of professionalism. We define professionalism as existing where, in respect of the same set of facts, two professionals would provide the same advice. Professionalism is a desired attribute of professional lawyers, doctors, accountants etc – each of which is trained to make scientifically based decisions and where the same facts exist, to provide the same advice in respect thereof.

Under current financial adviser training, (apart from that delivered by universities), critical thinking is marginalized. This form of training is little more than training to sell products and services which suit existing business models. For example, current financial adviser training assumes that actively managed funds which are benchmark aware are a suitable form of investment, despite the clear and consistent evidence that the majority of these funds under-perform their investment benchmarks (see below).

In this regard we submit that an urgent overhaul of the role and involvement of “registered training organizations” needs to be made. Under current rules for Registered Training Organisations (which can deliver vocational training to financial advisers, as well as to builders, nurses, etc), far more emphasis is placed on educational mapping than on the caliber of the teachers or course content. Registration of financial adviser education should be singled out for far better quality control than the current system allows.

We submit that any training course of any kind should only be delivered by a body registered under a new regime for "registered financial services training organizations" or universities. This regime should not be administered by state departments of education and should instead be registered by ASIC. The criteria for registration and the curriculum should be the subject of specific inquiry and should include the need for mandatory components of critical thinking.

No financial services institution should be allowed to provide any form of investment training, including continuing professional education, to any financial adviser.

CONSUMER WARNINGS

We submit that all investment products should have a comprehensive set of consumer warnings specifically based on the historical performance of the investment or the type of investment involved.

We submit that the highest priority for this type of warning should be in relation to traditional actively managed funds which are benchmark aware.

The consumer protection warning in the case of traditional actively managed funds should state that the majority of these funds do not achieve performance levels in line with passive stockmarket indices and that an investment in a passive index fund or exchange traded fund may be a superior form of investment.

We make this statement for a number of reasons:

1. The average managed fund under-performs it investment benchmark: APRA has commented in this regard:

   "…the average (funds management) firm under-performed their net benchmark by 0.9% per year…***this raises a question about the value of the active approach to risk management*** of investment portfolios and may support our doubt about the appropriateness of the Sharpe ratio in measuring performance…

   The net under-performance of the average firm appears more pronounced in down markets. This suggests either inactive risk management where investment managers appear to forego value adding opportunities in down markets or unsuccessful risk management in down markets perhaps due to costs…" (Sy W and Liu K: "Investment performance ranking of superannuation firms" (APRA Working Paper, 23 June 2009), p. 18

2. The average managed fund imposes a high tax cost on its investors which has been measured as equivalent to a cost of 0.6% pa (source: Towers Watson "Tax Effective Investing Report 2011)

3. The average managed fund underperforms passive index funds over a 3 to 5 year period: source: Standard & Poor's "SPIVA report"

INVESTMENT STRATEGIES FOR SMSFs

SMSFs are required by section 52 of the SIS Act to formulate and have regard to the risk involved in making holding and realizing investments. This is a key component of the regulation of SMSFs and is entirely unregulated. The ATO is not equipped to form a view on the probity of investment strategies and other than noting the existence of an investment strategy, it does not form a view on the utility or reasonableness of SMSF investment strategies.

We submit that SMSF trustees should be required to receive financial literacy training which should be the basis for their management of SMSF investments. We also submit that a panel of experts should be established to provide guidelines for investment strategies, depending on the range of circumstances which SMSF members can experience (eg age, retirement outcomes, account balance, etc).

In this regard we strongly oppose the mandating of specific asset or product types (such as the suggestion that SMSFs should be mandated to invest into annuities).

Tony Rumble PhD

26 August 2014