ASIC

Australian Securities & Investments Commission

Address to the Naval, Military and Air Force Club of South Australia (Inc)

Investing in 2009

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1. Introduction

1 Thank you for inviting me to come and speak to you today.

2 I have been the Deputy Chairman of ASIC since 2004. My focus at ASIC is on retail investors, their super, their financial advisers and stopping illegal schemes and scams. I think it is fair to say that the last year has probably been the most challenging yet, but I will reserve judgment for 2009.

3 Famous American investor Warren Buffett, has described the last year as a year when "investors of all stripes were left bloodied and confused, much as if they were small birds that had strayed into a badminton game." His legendary investment company, Berkshire Hathaway, has reported its worst results in history (reporting a 96% fall in quarterly profit last week) showing us that all investors have suffered in this market. This suggests to me that investing is more of an art than a science.

4 Today, I would like to give you a flavour of what I have seen over the past year from the perspective of the regulator and comment on a few key things that you will have been reading about in the press.

2. Fallout from the global financial crisis

5 First, let's do a stocktake of where we are now following the fallout of the global financial crisis (now called the GFC). There are many facts and figures of gloom that you will have been reading in the newspapers, so I won't go over all of them. There were just a couple that really stand out that I wanted to mention.

6 Official interest rates in the UK are now at 0.5%, the lowest rate since the Bank of England was founded in 1694, 315 years ago.

7 Citigroup's market value is down to US$9bn from US$277 billion in late 2006 and, as you know, has had to be 'rescued' three times by the US government.

8 General Electric, the AAA rated US engineering and financial services giant cut its dividend for the first time since 1938.

9 In Australia, we have had our first quarter of negative growth: the December quarter of 2008.

3. What caused the current crisis?

10 So how did we get here? Basically, between 1998 and 2007 we reached a period in the economic cycle of high confidence leading

to increased risk taking and increased leverage seeking higher and higher returns. There was excess global liquidity caused by massive surpluses in some countries. This, together with low interest rates, fuelled the US current account deficit in a vicious cycle. There were also some regulatory failures that enabled key players to take bigger and bigger risks.

11 The risks were mis-priced so when the bubble was burst by a huge number of bad loans not being repaid, the impacts were felt all over the world.

12 What we now know as the 'sub-prime' crisis started with bad lending practices in the US. There was a construction boom, low interest rates and competition between lenders. Government intervention also played a part. The 'American Dream' legislation that sought to give low-income earners the chance to own a home backfired and in 14 States in America a home loan is without recourse to the borrower; the lender's only claim is over the home. These factors fuelled a lot of borrowing by people who could not afford it.

13 Mortgage brokers benefited from bad lending, because they got paid commissions based on the numbers of mortgages they created. The quality of the loan did not matter to them because the risk of loss was passed on to the next person in the chain.

14 Similarly, investment bank executives were also incentivised to take risks to earn short-term profits with less regard for longer-term consequences. They bought the loans, repackaged them and then on-sold them with less incentive to look into the lending standards being applied.

15 It appears that many investors, market participants and possibly even credit rating agencies did not properly understand the risks of the products they were investing in. Investors relied on credit ratings agencies, who relied on the people creating the products, who relied on insurers and so on.

16 Then, in mid 2007, the cracks started to appear and we have been dealing with the fallout ever since.

4. So where are we now?

17 Whatever we do, it is likely to take some time for the global financial system and its economies to recover. There are mixed views about how long it will take. Some have been upbeat – in a recent speech in Sydney our Future Fund chairman David Murray thought there was cause for optimism. Some are in between - at an ASIC conference last week, Deutsche Bank's Australian CEO,

Chum Darvall, said he thought we were at the "half time orange break". And some are pessimistic – US economist Nouriel Roubini is talking about the risks of an L-shaped recovery rather than a U-shaped one.

5. Investor behaviour

18 There is a large element of human behaviour in this crisis. When times were good, no one wanted to leave the party early; there was a greater fear of missing out on the upside than the fear of losing money.

Swimming between the flags

19 One of ASIC's plans to use ideas about investor behaviour to help investors build wealth and avoid scams is the theme of 'swimming between the flags'.

20 We want investors to understand when they are 'swimming between the flags' – investing in things like bank deposits, a balanced portfolio of ASX listed investments and investments with known risks or with professional advice on the one hand. And, on the other hand, when they are swimming outside the flags – investing in riskier and more complex investments and beyond to unregulated investments and scams.

21 We want to get across the message that if you are between the flags you are investing in a safer section of the market; there are lifeguards looking out for you. There is still some risk. You can still drown or be stung by a blue bottle or bitten by a shark, but it is not as risky as swimming outside the flags (which you are allowed to do) where you are more or less on your own.

22 We are looking at using this metaphor to improve investor behaviour, including a greater awareness of things like diversification, asset allocation and risk-adjusted return. Many of the severe losses suffered by retail investors in recent years have involved them swimming outside the flags without realising it. Over time, we want to embed this image into the consciousness of as many retail investors as we can.

Preference for hindsight in the human brain

23 Science suggests that the frontal lobe of our brain looks backward for patterns and seeks to replicate past successes and avoid repeating past mistakes. This was useful for short-term survival, finding food and escaping sabre tooth tigers. However, it does not work so well when it comes to navigating abstract forward-looking investment markets.

24 This may be why investors get excited after they see a pattern of success emerge in the market. It leads us to be past performance chasers.

25 There is a parable from *The Economist* that explains the downside to being a past-performance chaser. It compared two investors starting with US$1 on New Year's Day 1900. Felicity Foresight was psychic and put her money into the best asset class every year for 99 years. Harry Hindsight put his money into the asset class that performed best in the year before and did this for 99 years.

26 By 2000, Felicity's US$1 would have been worth US$9.6 quintillion (that has 17 zeros after it) and Harry would have had US$783 (or US$290 after transaction costs).

27 Hindsight is a wonderful thing, Warren Buffett says the rearview mirror is clearer than the windshield, but this sad tale of Harry Hindsight reminds us that you have to keep looking through the windscreen, not so much for sabre tooth tigers but perhaps to avoid ending up on a badminton court...

6. Scams and swindles

28 Another key area of interest for ASIC in 2009 is illegal schemes and scams. We expect that there will be a rise in scams following the GFC. Peter Kell on the Australian Consumer Fraud Taskforce predicts that as many as one in twenty will fall victim to scams this year. In the UK, investor fraud has reached a 13 year high. The ACCC reports a 60% increase in complaints about scams and, of course on a global scale we have all heard of Messrs Madoff and Stanford (and I will say a bit more about them later).

29 ASIC's role is to identify and try to shut down these scams. Tracking them down is often hard enough, but another challenge is that even when we find a scam, it can be difficult to convince the victims to get out or not to put more money in. Not every investor wants to know about them – again, perhaps it's the human behaviour element. One time when our staff were calling investors to warn them not to put more money in, an investor thought their 'investment' in the scam was so good they tried to convince the ASIC staff member to invest.

30 Another key area we have been looking at is illegal early access to super. These schemes seem to be generally started in communities and affect less sophisticated investors. Often people realise that they can't access their super early, but might be induced in hard times or after recent unemployment. ASIC has taken action to

prosecute people involved in these schemes who have profited by taking a large cut from others' super.

31 The real problem for people who get caught up in these schemes is that they will not be eligible for compensation and might be subject to tax penalties!

32 Another kind of 'scam' ASIC is looking at that is not actually illegal is those unscrupulous letters that shareholders get in the mail offering to buy their shares for far less than they are worth (as made famous by David Tweed).

33 Under law, these offers are required to disclose clearly what the market price is for the shares. Despite these warnings and ASIC taking the people who make these offers to court, we are still seeing shareholders get caught out selling their shares for less than they are worth.

34 So, recently ASIC conducted some research to find out why shareholders accept these offers. Interestingly, our results showed that people either think it's a valid letter from the company or feel it's too hard to sell their shares and so accept the offer, even though they know it's a rip-off. We're now working on further law reform proposals with Treasury to deal with these offers.

7. Ponzi schemes

35 The *Madoff* and *Stanford* affairs in the US also remind us of the danger another kind of scam – the Ponzi scheme. Interestingly, the name 'Ponzi' comes to us from Charles Ponzi, an Italian immigrant who ran a now famous 'Ponzi scheme' in Boston using international reply postage coupons. These coupons could be sent to someone overseas where the recipient could exchange them for stamps and post something back; a form of 'reply paid' operating internationally.

36 The coupons were supposed to be exchanged at a uniform rate in each of the 63 member countries. However, the First World War caused some severe exchange rate dislocations. In countries like Spain, Ponzi noticed that coupons were very cheap in $US terms. For example, a coupon that cost US$0.01 in Spain might be redeemed for stamps worth $US0.06 in the US. On the face of it, this was a very profitable arbitrage.

37 He started the 'Securities Exchange Company' and offered investors a 50% return within 45 days. At the height of his success in July 1920, he was getting millions from investors who were mortgaging their homes and life-savings. However, it became obvious that there were simply not enough postal coupons on issue

to be funding his scheme and his liquidity was propped up by new 'investors' putting their money in.

38 The whole thing came crashing down and he was arrested in August 1920 with liabilities of $7 million and was sentenced to five years jail for mail fraud. It transpired that he had only ever bought about US$30 in coupons.

39 There are generally three elements of Ponzi schemes:

- an investment idea that is hard to value;
- an attractive return; and
- the first few rounds of investors being paid out.

40 The *Madoff* and *Stanford* Ponzi schemes also show that these schemes often target a specific community and feature flashy signs of money that no one wanted to miss out on.

8. Short selling

41 As you will have seen from the media, another area of focus for ASIC recently has been short selling.[1] Our view is that short selling can be useful for creating liquidity and allowing the market to 'discover' the correct price, the issue is one of transparency and whether it is used for market manipulation (eg short selling and then forcing the price down by spreading false rumours).

42 ASIC currently imposes a ban on covered short selling of certain financial stocks and this ban will continue until 31 May 2009, when ASIC will again review the ban.

43 ASIC initially imposed this ban along with regulators in many jurisdictions due to the concern that predatory short selling was putting important financial institutions at risk. Given the recent continued volatility in the share market, ASIC extended the ban to maintain confidence in financial stocks, such as banks and insurers at this time.

9. Hedge funds

44 Would you believe that the first hedge fund was created in 1949 by an Australian? Alfred Winslow Jones. Born in Melbourne to American parents, he was later a journalist for Fortune magazine who took up an interest in investing after writing an article on stock forecasting.

45 Jones' innovation was to short sell some stocks while holding others in the portfolio for longer-term investment, so that part of the general market risk was hedged out of the fund. His funds

were therefore more likely to perform according to the characteristics of the stocks selected, rather than general market trends. In other words, the intention was that the market was 'hedged' out of his portfolio.

10. Margin lending

46 There are different views about the usefulness versus the risks of leveraging (or borrowing money) to make investments. Some advisers will not recommend gearing into the share market to their clients (believing that debt and equity are like oil and water; they just don't mix) while others think that it is essential to build wealth for retirement.

47 The attraction of margin loans in a rising or 'bull' market is that they enable clients to increase their profits on the amount they actually invest; effectively getting a 'free ride' on the money they borrow from the bank.

48 However, in a falling market, the losses are potentially multiplied. As share prices fall, lenders will seek to protect themselves by making margin calls requiring the client to put in more money or sell their shares.

49 ASIC's view is that margin lending, when used appropriately, can offer benefits to investors including access to leverage that is relatively cheap and tax-effective. (However here we are only talking about the mainstream model of margin lending where the investor retains ownership of a portfolio subject to a mortgage in favour of a lender.)

50 We think it is important that investors are properly informed and the products are well designed (eg the investor can access live information about their investment). We are working on shorter, clearer disclosure documents for margin lending with the Government. There also needs to be good quality advice both about the margin loan and the equities.

11. What does all this mean for investing?

51 So, on a micro scale, some of the lessons we can all learn from this crisis include:

- Investing is an art, not a science.
- Do not invest in what you do not understand. (Or as the renowned investor Peter Lynch[2] put it, "never invest in an idea you cannot illustrate with a crayon").

- Swim between the flags – take on the level of risk that is right for you.
- Don't react with panic to changing market conditions. Be in your super for the long term (if you can).
- Scams – it is probably commonsense to this audience, but if it looks too good to be true then it probably is – that's a message for all of us again after Madoff.
- Diversify – don't follow the herd!
- Think of Harry Hindsight, keep looking through the windscreen– that's what's coming next!

End Notes

[1] In very simple terms, short selling is selling shares that you do not own in the hope that the market price will go down and you can buy the same shares back at a lower price. In the Australian market, using this technique means that you have to 'borrow' shares of the type and quantity you want to sell from someone else, sell those shares on the market and then buy the same type and quantity back later on when the price has fallen, hand those new shares back to the owner of the ones you borrowed and pocket the profit, less the cost of borrowing the shares. As you can see, the price has to fall for this strategy to work. If the price goes up, the short seller can lose a lot of money.

[2] Peter Lynch ran Fidelity's Magellan Fund, one of Wall Street's most famous investment funds, wrote several books, including *'Beating the Street'*, and coined the famous investment principle: "Invest in what you know".