Helping retail investors

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Introduction – ASIC's role

1 Thank you for giving me the opportunity to come back and speak to you again at this year's SPAA conference.

2 As usual, I notice that I have the tricky job of either preceding or following the Tax Commissioner.

3 Given that SMSFs are really a tax construct, you might be wondering what I can offer between tax and before morning tea? Many of you might sympathise with the guys in the cartoon I have up on the screen now; if you could just get rid of all the regulators your troubles would be over.

4 Unfortunately, for those who might hold a secret longing for a world with no regulators, it looks unlikely to happen in 2009. It is certainly shaping up to be a big year for ASIC.

5 At ASIC, as well as working with the ATO on SMSF integrity issues (like preventing illegal early access) we are concerned to ensure that retail investors are getting appropriate advice about the investments in their fund and the products they invest in come with appropriate disclosure.

6 As you know, ASIC does not regulate SMSFs in the way that it regulates corporations. While we register many of the corporations that act as trustees of SMSFs, these are small proprietary companies and enjoy a very light touch regulatory regime as corporations.[1] Advisers to SMSFs are subject to advice and disclosure obligations under the *Corporations Act 2001* regulated by ASIC and we have a general mandate to protect and educate retail investors. ASIC also takes enforcement action against illegal schemes and scams, including illegal early access to super schemes that use, or purport to use, the SMSF form.

7 At ASIC, we see SMSFs as retail investors and therefore our key focus is on financial literacy and investor education-related issues.

8 Today I would like to explore the themes that are important to ASIC in areas that impact SMSFs.

1. Retail investor messages

9 ASIC is looking to facilitate two key areas of investor understanding about SMSFs:

- At the entry point: They have sufficient information to make a decision about setting up an SMSF; and

- Ongoing: That SMSF investors are either getting proper advice or they understand key investment concepts such as asset allocation and risk-adjusted return.

10 In the future, I can see a much deeper role for ASIC in conveying messages about investment principles, primarily directed at SMSFs. We would do this for two reasons. First, obviously to educate and help investors. Second, and perhaps more powerfully, to raise the bar for advisers, making it more difficult for poor advice to be dispensed when information about core investment principles is more freely available.

11 An example of the sort of advice we would be seeking to prevent is the advice given to a number of retail investors, including many SMSFs, to invest in property-related high-yield fixed interest products like debentures. Not only were they often a very poor investment on a risk-adjusted return basis, but investors were often advised to allocate all of their investable savings to them. Going forward, we would expect that only the most foolhardy advisers would think for more than a moment about doing this.

12 Taking Westpoint as an example, ASIC has so far banned 22 licensed advisers, four unlicensed ones and a corporate entity in relation to advice on Westpoint products. The bannings ranged from three years in duration to bans that were permanent. ASIC is also taking action against six licensees to recover $69 million in compensation.

2. Swimming between the flags

13 To bring the idea that different types of investment carry different risks to the consciousness of everyday Australians, ASIC is using an image recognisable to all Australians: 'swimming between the flags.' If you're between the flags you're in a safer, patrolled section of the beach. Swimming between the flags still involves some risk, but not as much as outside the flags, where you are effectively on your own.

14 We want investors to understand when they are:

- swimming between the flags – investing in bank deposits, diversified blue chip shares, vanilla managed funds and other investments with known risks or with professional advice; and
- swimming outside the flags – investing in riskier and more complex investments and beyond, all the way to unregulated investments and scams.

15 It's that simple. We want investors to ask themselves the question when they are making an investment decision: "Where am I

swimming here; is it between the flags?" If the answer is that they might be swimming outside the flags, they have the following choices:

- Swim back within the flags;
- Get a stronger swimmer to go with them (ie get some independent advice); or
- Take the risk.

3. Where are SMSFs swimming?

16 The majority of investors say that they set up SMSFs to have more control over their investments. Most say they make the decisions about their fund, others say they leave this to their adviser.

17 So, clearly SMSF investors are a key group for the swimming between the flags messages because they are already choosing to opt-out of an APRA-regulated super fund. While many of these investors might have many years experience investing, we understand from the ANZ Survey of Financial Literacy published in October 2008, that as many as one in ten of those with relatively low levels of financial literacy were potentially the investment decision makers for their own super fund.

18 We have taken over Treasury's *Understanding Money* website and will soon be putting out a new-look website covering the field in financial literacy. One of our key ideas here is to put up some interactive tools to assist investors, including interactive tools that take investors through a number of key investing principles.

19 The aim is for this website to help deliver advice to the 80% of Australians who don't currently access professional advice and provide additional information and safety checks for those who do access such advice. This would include an online generic advice tool and tools to illustrate key concepts like diversification and asset allocation. The goal is to have the site operational by 1 July 2010.

20 We also plan to undertake a major research project into retirement income products and seek to influence the future design and marketing of these products to best protect the interests of retail investors.

4. Investing post-GFC

21 So what has the GFC meant for SMSF investors?

22 Everyone has struggled, just take a look at what has happened to the market capitalisation of the world's banks.

23 Let's take a look at a few basics:

- The Bank of England has just reduced the official interest rate to 0.5% pa, the lowest rate in 315 years.
- The ASX seems glued to Wall Street and, in US dollar terms, has fallen by around 65% since the end of 2007.
- Investor confidence has been shaken as the market has now been falling for nearly 18 months.

24 To quote a cartoon from *The New Yorker* magazine,[2] many of us have felt "the invisible hand of the marketplace, giving us the finger" and some of us might have looked for a place "to put our portfolio's ashes".[3]

25 Interestingly, the AMP Capital/Investment Trends SMSF Investor Report published in September 2008 found that 46% of SMSFs reported paper losses as a result of bad markets (and 35% said their portfolio had been slightly impacted).

26 More unexpected was that 66% said market volatility had made no difference to their investment approach. A quarter said they were buying under-valued assets and only four per cent planned to accumulate cash and wait for equity market to stabilise. Seven per cent of respondents said they had recently invested a large amount of new money into shares that had gone down.

27 Given that this data was collected in May and June last year, it might be that investor attitudes have changed now that the full impacts of the market downturn are being felt. However, it does reflect our general anecdotal understanding that many SMSFs are exercising discipline and continue to invest in blue chips, direct equities and term deposits. But, as could be expected, there has been a shift away from small caps and, interestingly, managed funds.

5. Messages for advisers

28 We understand that the general trend in the SMSF sector has been a growth in the use of advisers, that more planners are advising on SMSFs and SMSFs form a larger part of adviser business. At the same time, accountants might be looking to get into the advice space and provide advice about asset classes such as direct equities. Of course, they would need a licence to do this.

29 All advisers need to consider risk management about their advice to clients in a downturn. Given that investors are in a risk-averse

stage of the cycle and might be shifting to cash and capital guaranteed products, advisers need to be vigilant in managing conflicts of interest and advice appropriate to clients' risk appetite. As we all know, cash products are not a high source of commission income and so there is a growing tension created by the adviser remuneration model here.

30 At ASIC, we want to extend our 'swim between the flags message' to professional advisers so that getting advice is a key part of the behaviour that constitutes swimming between the flags.

31 ASIC's planned activities for the next financial year include a shadow shop in some form or other that will almost inevitably relate in some way to financial advice given to SMSF trustees. It is too early to say what we will be looking for, but the issue of commission-driven recommendations to invest in market-linked products has certainly been discussed internally.

6. Flawed products

32 The GFC has exposed a number of flawed products in our market place. It reminds me of the famous Warren Buffett saying about only seeing who is swimming naked when the tide goes out.

33 The evolution of the Australian financial services market has been characterised by innovation and this is obviously to be encouraged. Wholesale products have been adapted to work in the retail market, generally with positive outcomes for retail investors. An early example of this was the cash management trust; giving retail investors exposure to securities and rates of return that were previously not available to them on a small scale. Another innovation has been the funds management platform where increased scale has allowed access to products and managers previously only available to wholesale investors.

34 Unfortunately, this migration of products from wholesale to retail is not always foolproof, particularly where care is not taken to adjust the product for retail participation. Recent examples of this include taking the wholesale 'stock lending' model to the retail space, as in the case of Opes Prime. This has proved not to be a good move.

35 Also, we are now seeing many 'black-box'-type products that have behaved in unexpected and unpleasant ways in the hands of retail investors. It is in this environment where it is apt for advisers to ponder on the lessons that the GFC is teaching us. Advisers need to understand and question the products they are recommending to clients, rather than just distribute them. As was famously said by

Peter Lynch, who ran Fidelity's Magellan Fund for many years, "Never invest in an idea you can't illustrate with a crayon…"[4]

36 Also, we have seen products that retail investors thought they understood change their spots. A core investment of many SMSFs for many years has been the Australian listed property trust, more recently known as the A-REIT. The idea was that investors could get access to rent paid on Australia's premier shopping centres and office towers, along with some capital growth in a liquid (listed) form providing regular and predictable income. These were ideally suited to the SMSF.

37 With some exceptions, the A-REIT sector seems to have imploded, having chased fads, gearing and overseas investments; breaking many of the basic investment rules in the process. Examples include buying assets in markets not well understand by managers, opaque and over-complicated structures, over-leveraging and poor corporate governance. This has no doubt had a great impact on SMSFs and the confidence of retail investors.

38 In some respects, this is what we call a 'true to label' issue. Subtly, but obviously materially, A-REITs engaged in much more risky activities than was realised by the market and particularly, by retail investors. These are lessons that must be taken on board for the future.

7. Commonwealth Government bonds

39 A feature of the investment landscape for the foreseeable future is going to be the re-emergence of the Commonwealth Government bond as an investment and saving tool for retail investors. The Government has signalled that it will introduce legislation to raise at least $118 billion over the next four years. With yields currently at 3%, this will be attractive to many investors.

40 ASIC believes that the Cth Government bond should form the 'centre of the dartboard' of a retail investor's portfolio. Such bonds are the risk-free rate of return against which other riskier investments can be measured. For too long, this vital benchmark has been obscured, largely due to the repayment of public debt at the Commonwealth level.

41 There will be a need to reopen and modernise the channels through which retail investors get access to Cth Government bonds. ASX has already announced that it will have a role to play in the revival of the market for Cth Government bonds. For so long an investment almost exclusively used by wholesale investors, there is

a need for new ways for retail investors to participate; possibly online and in a user-friendly format.

42 The challenge for the Australian financial advice industry will be to capitalise on this important development for their clients in circumstances where commission-based remuneration will not be available. It would be a shame if the structural flaws in the industry prevented clients getting advice about bonds and having them at the centre of their portfolios. I am particularly talking about SMSFs here where the role played by the bond as a benchmark for pricing the risk attached to other investments is a vital part of good investing.

8. SMSFs and EDR schemes

43 Internal dispute resolution (**IDR**) and external dispute resolution (**EDR**) procedures do not directly apply to SMSFs in the sense that where a member has a complaint or problem about the fund they cannot go to a dispute run by the trustees or to the Superannuation Complaints Tribunal either.

44 However, EDR schemes are relevant to licensed advisers and to SMSF trustees who get advice from them. We recently consulted on our EDR policy, with fairly polarised results. One of our key aims for 2009 is to increase the monetary limit for investment complaints that can be heard by the Financial Ombudsman Scheme (**FOS**) to $280,000.

45 Currently, the limit is only $150,000. That's roughly half of the average value that an SMSF member has in their fund and roughly only a quarter of average fund value. And we understand that approximately 55% of SMSFs (211,000) got advice from a licensed adviser and 74% of their assets were under advice in July 2008.

46 What this means is that members/trustees of SMSFs might actually be the biggest stakeholder in this area; big consumers of advice with large monetary values attaching to that advice. SMSF members/trustees should therefore be keenly interested in the debate about a monetary limit that prevents their access to free EDR procedures where they get bad advice.

47 As we outlined at ASIC's oversight hearing before the Joint Committee on Corporations and Financial Services in December 2008, we recognise that the global financial crisis throws up issues for this proposal:

- On one hand, that there is likely to be a hardening insurance market making it more expensive and difficult to get insurance cover; and
- On the other hand, consumers are likely to be suffering greater losses and there is likely to be an increase in claims brought to EDR schemes. So, there is an argument that this is precisely when we need EDR schemes to be able to hear these claims. Consumers might also be less able to fund the costs of litigation.

48 We understand that the number of claims can as much as double in times of economic downturn and, historically, consumers who have suffered financial losses often because of economic and market conditions, have sought to find an avenue of redress by making a complaint to their adviser or financial services provider.

49 We have required FOS to submit its Terms of Reference to us by 1 July 2009, so our aim is to have the revised policy published in April 2009.

9. Disclosure

50 In 2009, ASIC will continue to facilitate the use of technology to improve information use for both consumers and industry.

51 Australia has the second highest Internet user per capita at 79.4% of the population. ASIC consumer testing also suggests that people with access to the Internet find web pages easier to use than a product disclosure statement (**PDS**) and people tend to rely on websites as a trusted source of information; they see it as their first port of call.

52 We recently commissioned research looking at how super fund members use the Internet to look for information about super.

53 What we found was that people preferred to use web pages than the PDS. Websites were seen as a trusted source of information, there was a reluctance to read the PDS because it was seen as technical and complex and hard to find online and they thought that PDSs would be standard for super anyway.

10. Inquiry into financial services and products

54 On Thursday, 26 February 2009, Bernie Ripoll MP, Chair of the Parliamentary Joint Committee on Corporations and Financial Services announced an inquiry into the underlying issues associated with recent financial services company collapses, including Storm Financial, Opes Prime and MFS. This will be one of the key forums this year for considering a number of issues

relevant to SMSFs on both the demand and supply sides. The inquiry will look at whether the regulatory environment is sufficient to deal with the range of products and services currently on offer.

55 The terms of reference cover:

- the role of advisers;
- remuneration models and conflicts of interest;
- the role of marketing and advertising in distribution;
- adequacy of licensing arrangements;
- appropriateness of advice and information provided to consumers, including the requirement to 'know the client' rather than to know what is in the best interests of the client;
- consumer education; and
- adequacy of professional indemnity insurance arrangements.

11. Projections and long-term returns

56 ASIC has been working on two projects aimed at educating people about the returns they should expect from their super. The first is a project aimed at giving members information about longer-term returns in their annual statements to help them appreciate that negative returns from time to time are not inconsistent with successful long-term investment. The second project is looking at how members can be given some form of personalised super forecast or 'super snapshot' of their likely end benefit. The likely outcome in most cases is that it will be less than they were expecting, possibly driving higher voluntary contributions.

57 At this stage, the project is not directed at SMSFs. However, given that SMSFs account for roughly one-third of the superannuation savings of Australians, it is likely that this work will spill over into the SMSF space. It is just as important that SMSF members understand the likely benefits accruing to them from their superannuation savings and we will direct our thinking to how this can be achieved.

12. Closing

58 In closing, if you are hoping for my forecast for the recovery in the year ahead, I think I will decline and leave you with a joke instead:

59 Have you heard the joke about the talking frog? A woman was approached the other day by a frog who explained that he had been

a human, but an investment banker had turned him into this ugly frog. He just needed a kiss, he said, and he could return to his real self, a forecasting economist! The woman picked up the frog and put him in her bag. "Hey, where's my kiss?" asked the frog. "These days, in this market, you are more use to me as a talking frog than an economic forecaster" she said.

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[1] There are of course specific duties falling on them and their directors under the *Superannuation Industry (Supervision) Act 1993* (***SIS Act***), but this is because the corporation is a trustee of an SMSF, not merely because it is a corporation.

[2] Charles Barsotti (cartoonist), *The New Yorker* magazine, 27 April 1998.

[3] Leo Cullum (cartoonist), *The New Yorker* magazine, 23 September 2002.

[4] Lynch, Peter – *Beating the Street*, 1994 Simon & Schuster, ISBN-13: 9780671891633