Addendum to submission to ASIC re MDAs
by Bruce Baker BSc MBA DFP, Puzzle Financial Advice
10/5/13

In my submission dated 3/5/13, I asserted as follows: "*Many smaller AFSLs have turned to the use of Limited Managed Discretion Accounts, to efficiently solve a problem that ASIC has refused to grapple with – that modern portfolio theory is broken and that timing does matter.*" This addendum is provided, just in case it is not obvious, some of the current evidence about why timing matters.

Background:
But first, in a very simplistic sense, let me characterise modern portfolio theory (as used by many financial planners) as follows:-

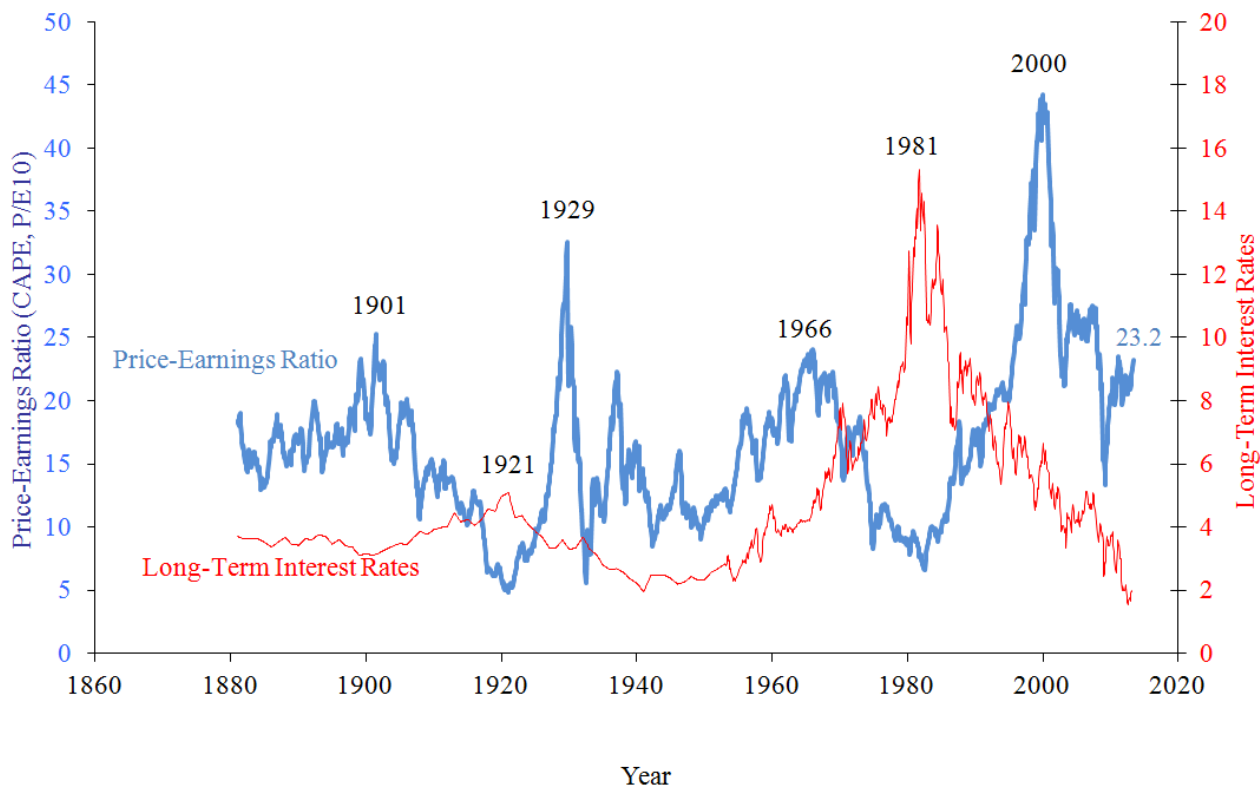
- To achieve a higher rate of investment return, simply
- ignore market timing,
- diversify widely,
- take on a greater percentage of risky assets like shares and property (i.e. less very secure cash & fixed interest) and
- ignore and ride the market volatility.

It all sounds so easy? If only investing was so easy.

But what are some of the problems with this formula?

1. Sometimes, risky assets do not produce higher returns even through periods that most investors regard as long-term. (Industry folklore from some wise old experienced advisors says that in effect, long-term is something like 3 years, because that is roughly the amount of time most investors are prepared to experience losses before sacking their advisor.) Risky assets do not even necessarily produce a good return over the long-term eg 20 years. So let me give you some examples of this? The US share market over the last 15 years – wild roller coaster over the last 15 years.

And the US share market is still very expensive on a long-term historical basis as can be seen by Professor Robert Shiller's long-term Price-Earnings chart. (The effect of historically extreme monetary conditions.)



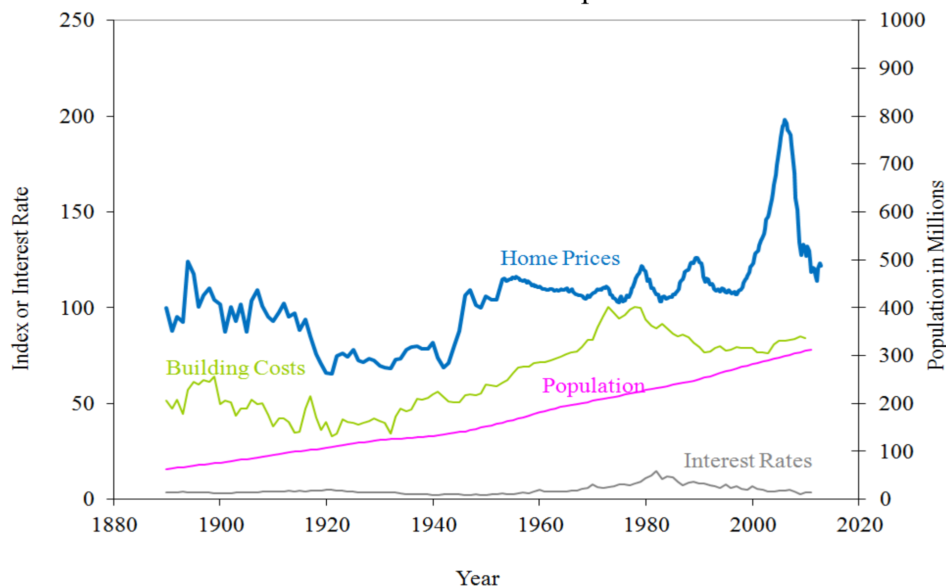
And there are studies (eg Jack Vogel's) that demonstrate that if you buy a broad-based diversified share portfolio when the market is historically expensive, you are highly likely to get a poor or negative return over the next 10 years.

2000 of course was the peak of the dot com, telco, growth stock bubble. And history shows that it never pays to buy a broad-based share portfolio during a bubble.

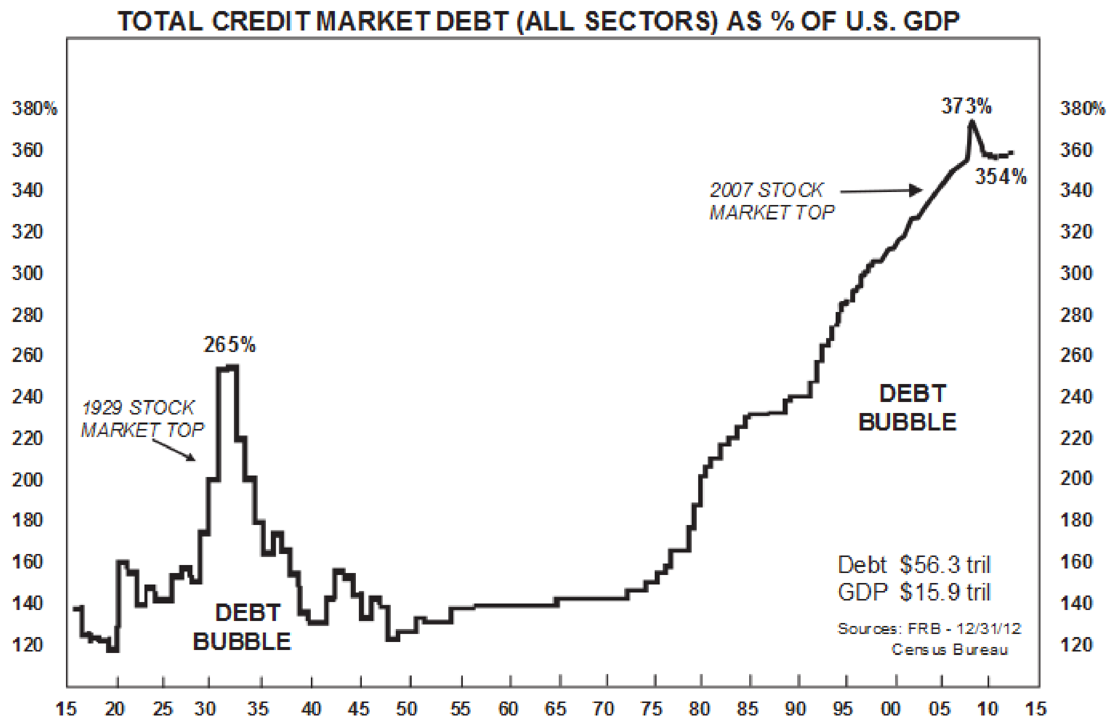
Of course, during this last 15 ("bubble") years, the USA also experienced a bursting of its house price bubble as can be seen in this Shiller-Case index of real house prices.

So, US investors have suffered large losses on two fronts – shares and property over the last 15 years.

And of course, it is important to note that investors (all around the world) tend to take a heavier weighting to domestic equities than international equities.



To state the obvious again I think, it is no co-incidence that these bubbles have peaked since 1995 when we have had massive expansion of the US money supply, money printing and a historically huge debt bubble.



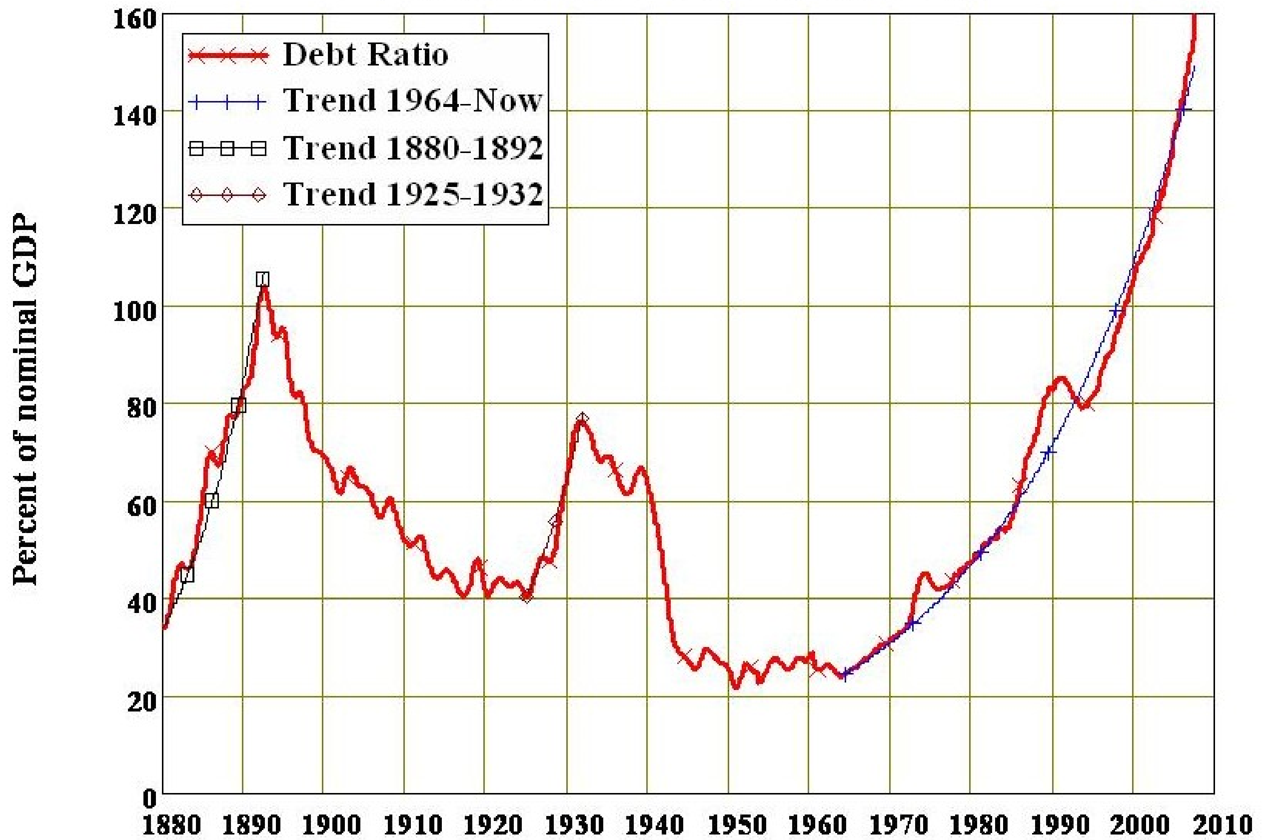
Surely, in the face of such historical extremes, it is unreasonable for advisors to ignore these factors – to ignore market timing.

But the USA is not unique of course. A lot of European markets and countries have experienced somewhat similar experiences as the USA over the last 15 years for the same reasons.

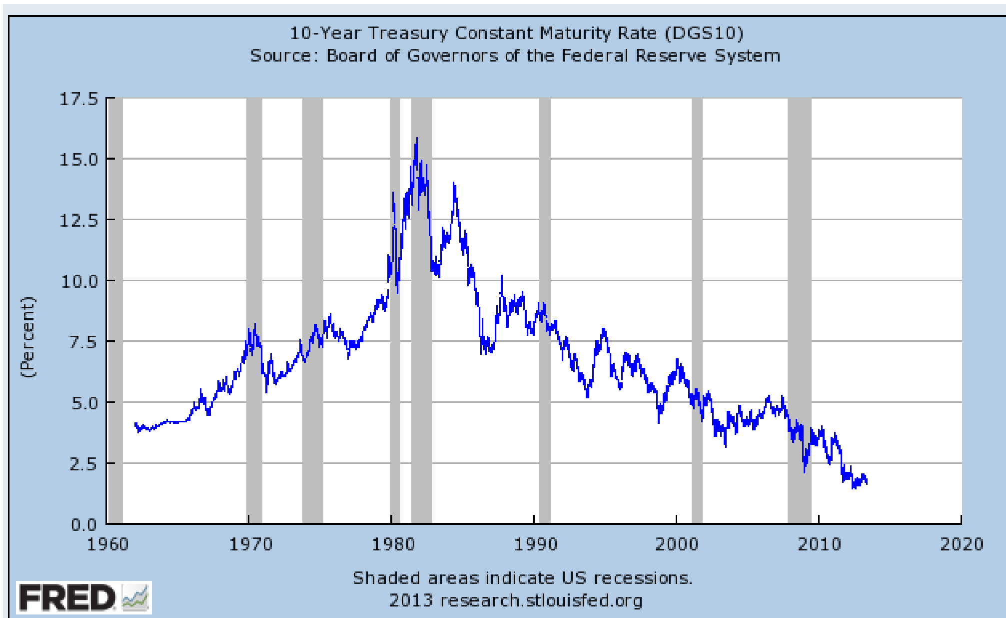
And then there is Japan, whose debt bubble peaked in 1989. Tough for long-term investors, who lost about 60%-70% in both shares and property in the crash of 1989. So much for diversification. But this only supports long-term research by the US Fed.

But if Europe suffered this fate, as did Japan, as did Europe (the majority of advanced economies) – surely Australia cannot be as arrogant as to think that it is immune to these sorts of problems.

And indeed, Australia does have a historical extreme debt bubble, like the US and much of Europe.

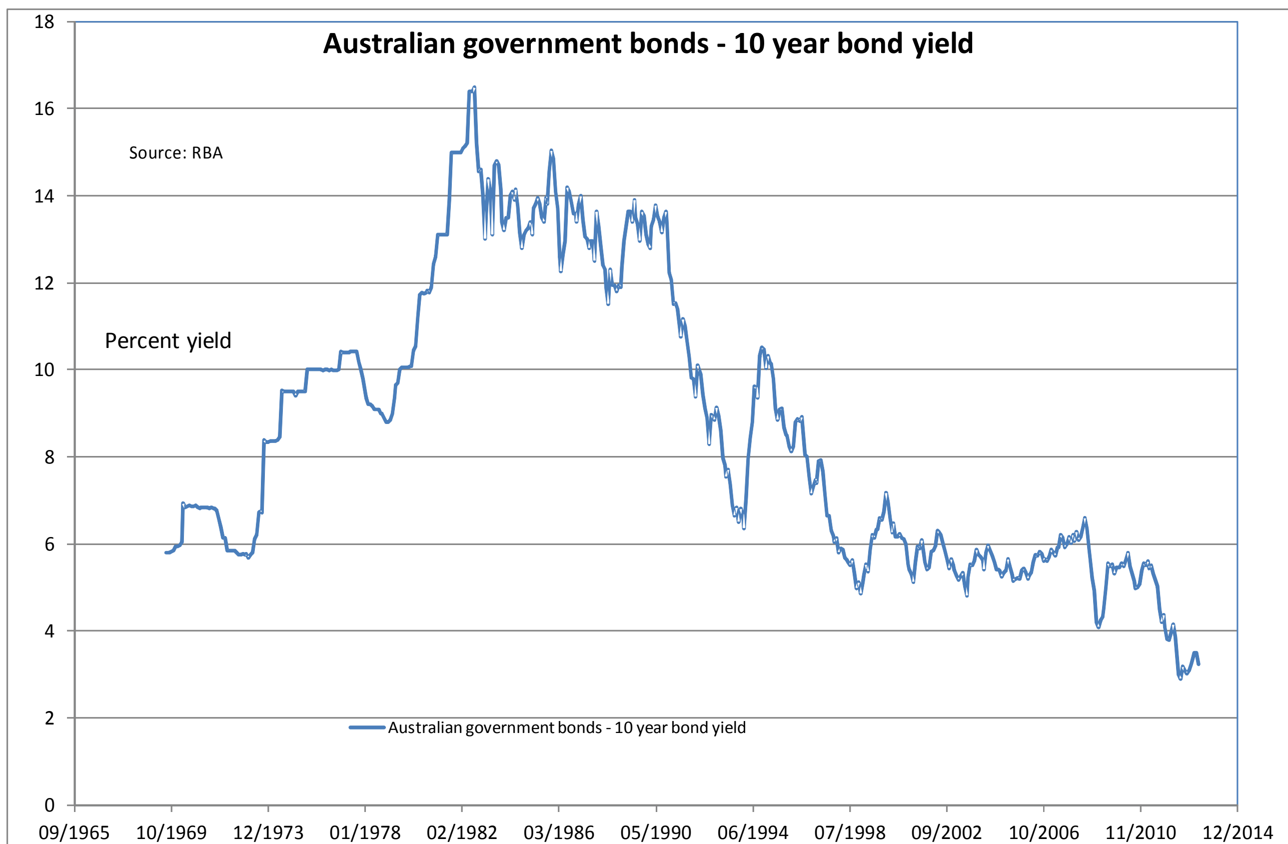


The above chart is from Professor Steve Keen.



And further, a number of very experienced analysts regard many of the government bonds as being the biggest bubble of them all after a 30 year bull market.

http://research.stlouisfed.org/fred2/series/DGS10



http://www.rba.gov.au/statistics/tables/#interest_rates

And then we have the currencies wars of course. There are a lot of different ways that this period is very different from "normal times" when it comes to investing.

And of course, to state another "obvious" factor with bubbles, they can crash very quickly. So it is important that a financial planner can quickly move clients from an area of danger very quickly.

Implications of the above for financial planners.

The ASIC discussion paper on MDAs gave me the impression that ASIC feels that financial planners who are not using MDA services, are not managing client money. (Reference paragraph 54 of ASIC discussion paper.) To the contrary, from my experience, the expectation of all clients who have an ongoing relationship with a financial planner, is that their financial planner is managing their money.

Therefore, the only issue to consider is how best to manage a clients money given the challenges and uncertainties that exist. For investors, I believe we are in a period of at least 10 years, where there is probably greater financial uncertainty that I can recall for Australian investors in the nearly 60 years of my life. And from my much longer-term historical studies of investment markets, I think this is one of the most extreme periods for Australian investors for the last 140 years – with only the 1930s Great Depression and the 1890s economic depression being in the same league. There is a distinct possibility that the current event (that perhaps commenced around 2000 and seems likely to continue past 2020) will turn out to be an even greater extreme event than the last 2 economic depressions – but only time will tell. And I have given you some of the evidence of how extreme the current period is.

Clearly then, in the face of these historically unusual times, a period of historical extremes, timing does matter. That does not mean that timing is easy. Clearly it is not. But surely an advisor ignoring timing in this period of extremes is being negligent – abrogating their obligations to their client. But

if timing is important, an advisor needs 2 things to deal with these problems:-

- the courage to do what is best for the client (i.e. to put the client's interests first) and
- a mechanism to change portfolios quickly and efficiently, when issues such as these threaten the financial position of clients. The very inefficient and slow process of SoA with reasonable basis followed by approval to go ahead, is far too costly for clients and often far too slow to react in time to rapidly changing markets as we see in bubbles.

Speaking of bubbles, here is a quote from Australian Financial Review 7/5/13 “Two reasons why RBA cut”. Christopher Joye writes as follows:-

> *The answer lies in the massive and historically unprecedented government interference in private asset markets: central banks and treasuries are responding to the bursting of one suite of housing and equities bubbles by printing trillions of dollars of new money to buy all manner of assets to blow even bigger, and possibly more destructive, new bubbles. There is, for instance, no precedent for the global government bond market bubble that we are experiencing today.*
> *It is almost the exact inverse of the 2001 “tech wreck”. The tech bubble was based on unrealistic expectations of future economic growth. The bond bubble is similarly predicated on the basis of unsustainably cheap money.*
> *Having pushed their cash rates to near zero in the aftermath of the GFC, central banks argued this was not enough. They launched their new and totally untested policy of quantitative easing: printing money to buy assets to drive up prices and reduce the implied cost of finance.*

So not only do we not have an efficient market (as modern portfolio theory) but we have markets that are being massively manipulated by governments and their central banks.

So tell me what the reasonable basis is to ignore markets timing in this period of historic bubble-blowing in asset prices, historic extreme monetary stimulation including historic extreme money printing, historic extreme personal debt bubbles, historically large government debt bubbles in the developed world and a historic shift in the balance of economic power from the developed world to the developing world.
We live in a world where developed world central bankers have embarked into unchartered territory and cannot know the medium-term ramifications of their monetary strategies – so surely then a long-term invest and forget strategy, ignoring market timing seems little more than randomly rolling the dice in these times – and hence does not seem to have a reasonable basis.

> Here is a comment from Warren Buffett on this from http://www.cnbc.com/id/100707968
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> > *In response to a question on the Federal Reserve's massive quantitative easingprogram, Buffett said it will be "the shot heard around the world" when the central bank first indicates it will stop buying financial assets or start selling from their now enormous $3.4 trillion balance sheet. "**we're in uncharted territory** ... that's a lot of securities."*
> >
> > *Because that liquidity has been supporting stock prices, people in the market will immediately reevaluate their positions.*
> >
> > *Even so, he said, "the world won't end" and the market will survive. He repeated his long-held "faith" in Fed chief Ben Bernanke and said "we have benefited significantly, and the country has benefited significantly" by the Fed's actions.*
> >
> > *Conceding the Fed's buying program is a "huge experiment," Buffett said, "This is like watching a good movie, and I do not know the end."*

Conclusion:

It would seem clear therefore necessary to pursue more considered strategies during these times, and to be prepared to adjust those strategies as the outlook changes. Therefore, the traditional financial planning approach is NOT well-suited to these times. A managed discretionary account makes it more efficient, more timely and more practical to deal with these times.

ASIC needs to ensure that it does not remove this important tool that clients need in these challenging times.

About the financial planning practice of Bruce Baker.

Puzzle Financial Advice only has a small group of clients, to who we have provided a very personal service over a very long time. A lot of our clients have a very good understanding of investment markets, economics and business – and I always appreciate their feedback, input and ideas.

The average client relationship we have with clients is in excess of 10 years. I think this is a factor in considering how a portfolio should be managed – and how the relationship works with our clients.

Bruce Baker has been advising clients for 20 years. Even though the regulations do not give credit for experience, experience does matter when it comes to investment advice and investing. This is one field where you never stop learning.

We put a lot of effort into helping our clients understand what is happening in the financial world, and what the ramifications are for our investments – and for where we should invest. This includes typically, multiple circulars each week. So clients regularly receive updates to the "reasonable bases" that we have for investment recommendations and decisions. This is part of our policy of being very accountable to our clients.

Clients can monitor their portfolio via Xplan (on the Internet) and can also monitor most of their volatile assets directly on the web site of the IDPS we use for clients. This is part of our policy of being as accountable to our clients as possible.

Note:-

- We have been a fee-for-service business for a very long-time eg 15+ years
- We have rebated commissions to clients where we can for a very long time – and where we have not been able to, we credited commissions to clients to reduce fees otherwise payable.
- We have never accepted platform rebates, volume rebates, volume over-rides and any similar payments from fund managers – as we have sought to minimise all conflicts of interest as best we can.
- We do not accept any form of soft-dollars from fund managers.
- We are paid by the client – by itemised invoice, as part of policy of being as open and accountable to our clients as we can.

Attachment:-

- Australian Financial Review Article 7/5/13 "Two reasons why RBA cut".