

PROVOCATEUR

Are you an agent for me or my money?

PAUL RESNIK starts the New Year with a number of concerns that go to the heart of public confidence in financial planning.

Much of what is wrong in financial planning will be found in the very public unravelling of the Storm Financial Group. Time and the courts will tell if there has been any form of illegality. In the meantime, the nature of their business model will become more open to public view.

I have no doubt the community's confidence in the integrity of the financial planning services available to them will continue to be severely undermined by a number of issues that have emerged to date:

- First, the riskiness of the plans and product recommendations seem to have been unrelated to the risk tolerance of Storm clients. Rather, there are fears they have been structured to maximise revenue for the Storm business.

- Secondly, last year's dividend paid to the founders of Storm is mystifying when judged against conventional accounting standards.

- Thirdly, despite claiming independence, Storm appears to have had many links to institutional product suppliers that appear inconsistent with the ordinary use of the term 'independent'.

- Finally, the Financial Planning Association (FPA) appears too meek to condemn a misuse of financial products so blatant that it clearly breaches the fiduciary responsibilities inherent in the role of the financial planner.

Each issue in its own way is disturbing, combined they leave both the financial planning profession and wider community more than a little apprehensive. Confidence lost creates a vacuum that frequently gets filled by new and more brutal regulation.

The story so far

This is what I understand from public records, Statements of Advice and reports in the media:

- Storm Financial, in various guises, has been in operation for more than 35 years;

- an attempt was made to float the profitable business in late 2007 but an underwriter could not be found;

- Storm was a principal member of the FPA and employed a number of Certified Financial Planners;

- the business charged high initial fees of 7 per cent to 8 per cent and received moderate trails from Storm-branded products issued by major investment houses;

- some client portfolios were maximised for equity exposure using double gearing (money borrowed against the home leveraged further through margin loans);



- some of the highly geared clients were in their late 70s;

- increases in investment and home values were crystallised and reinvested incurring further initial fees;

- during or after fiscal year 2008 the dividend paid to founders was \$24.1 million on a profit of \$26 million;

- in the last part of 2008 new business volumes declined; and

- the business could no longer meet its financial obligations as they fell due and is now being wound up.

Consequently:

- many clients have lost more money than they thought was possible or, in many cases, could afford to lose;

- it took the Australian Securities and Investments Commission (ASIC) until December 2008 to commence a formal inquiry;

- some clients will be looking for new advisers;

- some clients will never trust an adviser again;

- some clients will be taking legal action;

- some clients may contact their local Member urging a Senate inquiry; and

- some in the Labor Government may relish the opportunity to clip the wings of the financial services sector (you might remember their last effort – industry funds).

The media is having a field day but this will soon pass as they move onto

other matters. However, the shame file is growing; just add the Storm debacle to the top of the pile containing Westpoint and the other examples of advice gone wrong.

Interview reveals risk bias

An unfortunate behaviour I suspect is common to many other financial planners and planning groups is the projection of the financial planner's risk tolerance on to their clients.

This is best exemplified in this exchange reported in the *Townsville Bulletin* on January 7 this year between business editor Tony Raggatt, and Emmanuel and Julie Cassimatis, the founders of the Storm Financial Group.

"What do you say to all those people who have lost or will lose their homes and life savings?"

"It is important that you know that the founders of Storm, along with most advisers and key staff, are all in the same boat as some of our clients. We have all followed the same investment and lending within our portfolios, have our homes mortgaged and have suffered the declines in the markets due to the financial crisis. We are also a large part of the negative equity issue.

"While this is no consolation, we're sure it proves we have not acted differently for ourselves. Being [on] the front-line of course makes us the first casualties and, as such, the Storm group



accounts for the biggest losses alongside the group of clients [who] are in that position."

While in other businesses it's not unreasonable for the salesperson to say they eat their own bread, it is clearly inconsistent for a professional financial planner to give all clients a similar and very risky strategy.

It seems all in Storm believed their message. It is claimed everyone lost money, staff and clients alike. It would appear, to an outsider, Storm simply projected its corporate risk tolerance onto its clients. If so, this would show little regard for legal and professional niceties such as the 'know the client' and 'know your product' obligations and anything remotely similar to matching products to the needs of clients.

Indeed, it has been reported that the driver of how much risk the client needed to take was a financial calculator driven by free cash flow to optimise home equity and margin loans, which in turn maximised assets and loans under management. In the Statement of Advice I reviewed there was certainly no mention at all of risk tolerance.

Storm's fee structures

Storm's policy was to encourage clients to take on a high upfront fee and relatively low ongoing fee structure, claiming in the long term it provided better value for clients than the more traditional low establishment and higher ongoing fee structure of competing planners. As far as I can tell, the ongoing fees charged were in the vicinity of 1.15 per cent per annum.

In the Statement of Advice I reviewed, the fee to Storm was not paid by the fund managers but as a direct reduction from the moneys borrowed.

A mismatch of income to expenses?

In essence, the Storm business model could only work in good markets. It appears to have floundered as markets declined, when there were fewer new clients and lower numbers of existing clients able to top up their investments from realised profits. As business diminished during the second half of 2008

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working capital was obviously under pressure. Nonetheless, the business still paid a dividend of \$24 million-plus to its founding owners – a surprising payment given the apparent cash flow issues.

Would Storm have become insolvent so quickly if the ‘profit’ and ensuing ‘dividend’ had been accounted for in a more orthodox manner?

Clearly, the ‘profit’ was based on the high upfront fees that were designated to pay for ongoing client service. This looks to be fundamentally inconsistent with the basic accounting standard that demands revenue be matched to future expenses. A more traditional treatment would have been to view the majority of the initial fees not as revenue but as a future liability.

The problem of agency

One of the more confronting issues that emerged over recent days is the relationship between lenders, fund managers and Storm.

Storm was an ostensibly ‘independent’ financial planning group but had seemingly strong ties to a number of financial institutions that provided investment and lending products and

facilities (not unlike many other ‘independent’ financial planning groups). It is therefore not surprising to read media suggestions that the payments and other support from product suppliers led to bias.

The grey area of agency needs to be explored with some care. The client’s financial plans often demanded that at least one loan be taken out. On the face of it, if the planner helped in processing an application and received any form of remuneration, it is difficult to argue that the planner is not an agent for the lender.

■ How does this reconcile with planners’ professional and fiduciary obligation to the client?

■ What level and type of disclosure of allowances, commissions, royalties and so on is sufficient to allow the defence of ‘buyer beware’ to stand?

■ Who are planners like Storm representing and how is the client to know?

Once again we arrive at a core structural problem in the industry. Once more I suspect we will need to look at whether we label those who are obviously product salespersons to clearly differentiate them from those who are fiduciary financial planners.

Why is the FPA’s CEO defending margin lending?

I have to be careful here as I

am relying on a news report from the *Money Management* e-newsletter of January 16. I risk offending both the *MM* editor and the chief executive of the FPA. Nevertheless, the comments as reported seem so extreme they at least deserve to be raised so they can be clarified.

Bloch said while margin lending is a model that has risks, it is one “people have done extremely well out of”.

“If you start pointing fingers at Storm and their business model then you’re going to have to start looking at a whole range of other issues like hedge funds and all sorts of other instruments,” Bloch said.

I believe those fingers are already being pointed, and will soon start waving disapprovingly. If I’m right, the industry should be worried because those fingers are attached to the arms of regulators. And not the namby-pamby ‘regulators’ of the last decade and a half; I’m talking about black-letter law, hard edged, go-to-jail regulators. Bloch seems to see it quite differently.

“I don’t think we’re quite close to running a nanny state just yet, where we determine what’s good and what’s bad; I think people need to go into these things with their eyes wide open.” Bloch said it’s important

for investors to understand “for all the risk and return there are ups and there are downs, and that’s what we’re facing at the moment”.

What will it take for the FPA to say, ‘This has to stop’. Instead of resorting to a ‘nanny-state’ defence, what will it take for the FPA to condemn the clear abuse of product, process and client?

Giving debt to many of Storm’s clients was akin to giving whisky to a two-year-old child. Does society ban whisky? No. But does it condemn and sanction people who would give that whisky to a two-year-old? Yes. That is the argument here – and it appears the FPA is unprepared to engage in it.

Individuals and their families who choose to pay for the advice of a financial planner should be able to reasonably expect that advice to be in their interests – not the planner’s. They should be able to expect that they will not walk out of a planner’s office with a ticking time bomb in their hands.

A significant number of Storm’s clients were aggressively double geared, which is widely regarded as a very risky strategy. What’s in question here is the quality and integrity of advice, not clients’ understanding of the potentially toxic mix of investment risk and margin lending.

Perhaps financial planners need a specific professional qualification and proven experience before being able to promote gearing?

Before recommending a margin loan, client portfolios need to be robustly ‘stress tested’. There are many ways to do this, including:

■ Monte Carlo simulation;

■ back testing of the total client portfolio (home, debt, investment portfolio, etc) through past extreme events, such as 1987, 1994, 1998, 2000 and, now, 2008;

■ mean variance analysis with correlations between markets being increased towards 1.00, reflecting the effects of contagion across markets at times of extreme stress; and

■ creating hypothetical ‘black swan’ events and examining the impact on the total client portfolio.

I suspect 90 per cent of financial planners would be unaware of these processes, let alone undertaking such risk evaluation checks and sharing the results with their clients.

Margin lending may not be such a good idea if clients make extra returns for 19 years and then lose everything in year 20.

What will happen?

The community will continue to lose confidence in the players of the financial system, particularly bankers, fund managers and financial planners.

We can expect significant re-regulation. This will be inevitable given the political necessity of needing to be seen to be active.

What I have seen of the rules over the years is that they can so easily replace personal integrity. ‘If the rules don’t disallow something explicitly then it’s okay to do it’ has become the norm.

We need to find and apply a higher standard of personal behaviour. I suspect that can be found in the process of seeking clients’ properly informed commitment to both their financial plans and the riskiness of the products, which is the core of a robust financial planning process.

Properly informed commitment needs to be built on a foundation that encompasses at least three of the components that go to make up personal financial literacy. Each client needs to:

1. know their (and any partner’s) financial risk tolerance;

2. know their capacity to cope with a financial loss in both the longer and shorter term; and

3. have at least a basic understanding of money, investment and tax issues;

Prospective clients need to understand whether their planner is an agent for a product manufacturer or represent their (the client’s) interests solely.

It’s far from a storm in a teacup; it just might be a storm that leads to a Senate Inquiry. And remember, that Senate is no longer controlled by a finance sector-friendly Liberal Government and any inquiry will occur in an environment where ‘good government’ just might be ‘heavy-handed regulation’ government.

Welcome to 2009.

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