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### Daniel Foggo on why P2P lending is not what you think

Graham Hand

*Daniel Foggo is the Chief Executive Officer of RateSetter, Australia's largest peer-to-peer (P2P) platform, now commonly called marketplace lending.*

**GH:** You're approaching your fifth anniversary. How has the peer-to-peer or marketplace lending business in Australia, and RateSetter, progressed versus your initial plan?

**DF:** Very much in line with our expectations. When we started, we believed we were building a structural alternative to the bank model. We were moving consumer loans from funding by bank deposits into a new investment class for investors and opening it up. From day one, we wanted a comprehensive reporting environment and to move away from a negative reporting environment to make sure that our credit performed.

**GH:** What's a negative reporting environment?

**DF:** It's when a consumer applies for a loan, the lender looks up the applicant's credit file to learn if they have previously defaulted. When we launched, the Australian credit bureaus didn't offer the granularity of information we wanted but that has now changed, and we have a much better ability to assess credit. The building blocks of the business have been around credit standards and we've funded almost \$600 million of loans. The loss rate to date is under 1.8% of what we've funded.

**GH:** Is that of the number of loans or of the amount you have lent?

**DF:** Of the total amount. We offer granular risk-adjusted pricing to our borrowers and pleasingly our credit models have proven accurate in the rank order of losses. And the independent Provision Fund held in trust has covered every one of those losses and still represents about 6% of our loans outstanding on our retail book. Borrowers pay different amounts into the Provision Fund, depending on their credit characteristics.

We've had to build profile with both investors and borrowers. We obviously advertise and feature on comparison sites to attract customers, and we work with corporate partners. For example, we integrate with installers of renewable energy products and different battery, energy and solar panel companies for loans on

our renewable energy lending markets. It's important to reach scale, especially finding ways to attract good borrowers.

**GH:** A lot of readers might think that a 'marketplace' is like eBay where anyone can put up an item for sale. What borrower checks do you perform?

**DF:** Well, we call ourselves a marketplace lender and we do operate several markets through which investors can access loans. However, the term maybe disguises the fact that in many respects we are a fund manager, only we are specifically focused on consumer credit. We think of ourselves as fund managers focused on consumer credit, and we need to ensure returns are reliable. Less than 10% of the people who want a loan from us will have it funded because we decline most people.

**GH:** I'm surprised it's so low.

**DF:** We decline loan applicants at different stages where they don't meet our credit criteria. About 40% of applicants don't even get through to our application form because they don't meet our initial criteria. Once people go through an application, they might be declined immediately based on some of the information they provide. Or they might get through to our underwriting team and get declined there.

**GH:** Why might someone get declined?

**DF:** Our loan underwriting process is not dissimilar to that performed by a bank or other traditional lenders. We collect information from the applicant and use third party information sources for form a view on their credit strength and the suitability of the loan they've applied for. We use the Government's document verification service to assist in our credit checks. We also check the applicant's credit file with a credit bureau. We typically also require bank statements from the applicant to support our diligence on identity, income, expenses and any other debts. We go through all the usual processes that are required under the National Consumer Credit Protection Act 2009. Amongst other responsible lending obligations, we must ensure the loan will not place the borrower in financial hardship and that the loan is for a suitable purpose. For example, paying off a holiday over five years does not make sense.

The second component of making sure it's a sound investment option is how we price risk. We not only want to fund the right people, but we put aside enough money to cover expected future losses.

**GH:** How is the interest rate on a loan determined?

**DF:** The base funding rate is the same whether the client is an 'A' borrower or a 'B' borrower. What is different is how much the borrower pays into the Provision Fund. That may be a fee up front or part of their interest rate. So, Joe might borrow at 7% but Jim might pay 10%. Joe owns his own home and has a stable job, while Jim is a tenant who might change jobs more regularly. Joe might be paying 2% into the Provision Fund while Jim is paying 5% of the outstanding loan balance. It's representative of the risk.

However, the investor is receiving say 6% whether they are funding Joe or Jim, and both are protected from default by the Provision Fund.

**GH:** Let's focus on the Provision Fund, because not all marketplace businesses use them. If I'm an investor and my borrower places say 2% into the Provision Fund, if the loan defaults, I have access to the full 100% of my loan, not only the 2%, right?

**DF:** Yes, it's not just the amount your borrower puts in. Rather, you as an investor have the benefit of all the money paid into the Fund over the last five years. It delivers a diversification of credit risk and the Fund currently has \$14 million in it. Our expected losses on loans outstanding are about \$9 million, giving a 1.6 times coverage ratio.

**GH:** And that \$9 million is based on your experience with the types of borrowers in your loan portfolio?

**DF:** Exactly. We analyse our loan book daily, not dissimilar to the way a bank forecasts expected losses. We have enough loss curve data to have a good understanding and we can quite accurately assess the loss rate. Clearly, if the economic environment changes, we need to take those things into consideration as well.

**GH:** Given your rigorous lending process, what are some of the main reasons for defaults? What happens to people?

**DF:** It's generally a change in personal financial circumstances. In line with industry averages, about a quarter of losses are associated with some sort of bankruptcy. The remainder might be losing a job or health issues, but there's a diverse range of reasons.

**GH:** What's your process for chasing a default?

**DF:** We seek to cure loans in arrears for the first 45 days and we have a successful track record doing that. If a loan remains in arrears beyond this period, then we work with three different collections agencies to support our collections efforts. These agencies are regulated businesses and they operate on a contingency basis, and given our scale, we ensure there's competitive tension around their services.

**GH:** Which bank products are you replacing?

**DF:** The key trend is the decline in credit card usage. Card spending has remained stable but the balances where customers are paying interest have declined. People are looking for alternative ways to hold that sort of debt and personal loans are a good solution. Also, personal loan market share of the Big Four banks has fallen over recent years. Businesses like RateSetter have gained meaningful market share.

**GH:** How does it work for an investor if I want a strong borrower, a homeowner with good income, buying a solar system for their house. What do I find out about the borrower? Can I know how much of their home they own or their income?

**DF:** We believe we're in a better position to understand the credit characteristics of the borrower than our investors. We've got more information available to us to price their credit risk. It includes information from a credit bureau that we can't pass on to an investor. That's why we think the model works better with us as a manager of consumer credit, where the investor relies on us to manage the risk, rather than the investor choosing the specific borrowers they want to back.

To gain the investor's trust, we do various things. We make sure we maintain a good track record, we are transparent by providing information to our investors and we have the Provision Fund. If we relied on the marketplace model by saying, "You go away and assess that credit and make a judgment", we don't think that model would work very well. Most investors are not experts in credit, nor do they know how to minimise risks appropriate to them.

Investors don't see a lot of information about the borrowers they have funded. However, every quarter, we upload our whole loan book onto our website so investors can see every loan we've funded. We include information on the age of customers, the credit bands and whether they are homeowners.

**GH:** Tell us about the characteristics of your investors, including SMSFs?

**DF:** Sure, there's a great diversity among our investors. SMSFs represent about 20% of our retail lending by funded amount and it continues to grow. The average amount invested by an SMSF is about \$90,000.

**GH:** That's significantly more than I expected.

**DF:** Yes, whereas the typical non-super retail investor averages about \$20,000 and that's where most funding comes from. Our investors are typically aged 45 and over and investing in our five-year, higher-rate markets, looking for yield outside of super. But that masks a lot of relatively young investors who are investing smaller amounts. About 75% of our investors are male.

**GH:** And what about institutions?

**DF:** We were delighted to introduce Future Super, the leading fossil-free superannuation fund, to our investor base last month. We also have the support of some fixed income funds, some financial advisers who have put their clients in. The Government's Clean Energy Finance Corporation invests alongside other investors in the renewable energy lending markets. We went through 12 months of due diligence to get them comfortable with our business model and underwriting process. Plus, we have a small number of ADIs (*Authorised Deposit-taking Institutions*).

Our investors are looking for strong fixed income returns, and our investor surveys show over 80% have shifted money from term deposits or savings accounts into their RateSetter account. We often describe RateSetter as offering an attractive middle ground between the safety of deposits with a government guarantee and equities which can be more volatile.

**GH:** How do you respond to arguments that marketplace lending has not been through a recession in Australia?

**DF:** We are funding the same borrowers who in the past would have borrowed from a bank. We have not found a new class of borrowers so there's no reason our borrower loans will perform in a materially-different manner in a recession. In fact, our losses are less than large banks typically experience on 'new-to-bank' customers, which are typically around 6%. This is because our checks are more vigorous and our loss rates are around half that level.

Also, the asset class we're investing in is highly resilient. Australia has not had a recession in the last 20 years but if you look at credit performance in the UK and the US during the financial crisis, consumer credit outperformed small business credit, large business credit, property lending and even in the US, mortgage lending.

The other component of our asset resilience is our short duration loans, averaging a little over three years. Plus, we have the Provision Fund.

**GH:** Do you think there is a general preconception in the market that your borrowers are people who can't borrow elsewhere?

**DF:** It depends how much time people have spent looking at us and our history. Investors just need to go to the statistics page on our website to understand the type of borrowers we fund. There are two types of people who come to us: those who can't get finance elsewhere and those who come to us for a better deal. It's the latter type we're good at tapping into.

Over 2,000 borrowers have reviewed our offering on [Product Preview](#) and it gives a sense of the type of people we lend to and what they care about. These are not people who couldn't get financing elsewhere. They're refinancing their credit card or improving their kitchen.

**GH:** Can you explain what people do with the money, especially the green and automotive loans and what some new areas might be.

**DF:** We're looking after good credit customers through their life cycle. When they are relatively young, they might need a small loan for a holiday or wedding, for example. When further along in life and applying for a mortgage, they might want to improve their financial situation by consolidating their credit cards into lower monthly cash flows. After they buy their home, they might refurbish the kitchen. About 60% of people who buy a new home then buy a new car in the next 12 months. Then they might send their kids to private school.

About 40% of our customers are looking for a better value alternative to existing finance and that's most commonly credit card debt. The next most common is automotive finance and the third is home improvement. Then there's a long tail of reasons such as weddings, holidays, medical. We want a diversity of terms, purposes, geography.

A growth area is that more people care about the environment and they want solar panels and maybe a battery. When we think about the future, we want to have an impact on electric vehicle finance, because with it brings together our experience in renewables and automotive finance.

**GH:** Finally, what do you think of this confusion of names, such as peer-to-peer lending and marketplace lending?

**DF:** It's a misnomer in many ways. We're more akin to fund managers. It's taken us time to realise that in many ways. We live and die by credit performance.

We are giving people access to an asset class, and a key competitive advantage of ours is not being reliant on wholesale funding lines that can come and go. We've had record numbers of investors sign up each of the last three months, and undoubtedly low interest rates are one of the reasons behind that. They are placing investments with a fund manager.

*Graham Hand is Managing Editor of Cuffelinks. Daniel Foggo is CEO of [RateSetter](#), Australia's largest peer-to-peer lender, and a sponsor of Cuffelinks. This article is for general information purposes only and does not consider the circumstances of any investor. Investors should make their own independent enquiries and consult with a financial adviser.*

*For more articles and papers from RateSetter, please [click here](#).*

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## Most investors are wrong on dividend yield as income

Peter Thornhill

Market commentators and investors regularly use the wrong metric and distort the investment dialogue on yield and income. Let me start this by reminding everyone of my preferred definition of investing: 'the use of money to produce a regular income'. Contrast this with the definition of speculation: 'buying and selling in an attempt to benefit from a fluctuation in the price'.

In general, the profit of a company is split broadly in two:

1. retained earnings for R&D, new technology etc and
2. the balance, or payout ratio, as a dividend.

In mature, quality companies, earnings drive dividends and it is dividend growth, reflecting growing earnings, that ultimately drives share price performance.

In an article in *The Sydney Morning Herald* by Elizabeth Knight, she writes on CSL:

*"This is an old-fashioned growth stock - one that lifts profit every year - and ploughs much of it back into research and development and boosts its capital expenditure. It traditionally spends about 10 per cent of revenue on R&D and is currently working on, among other things, a \$US550 million (\$810 million) clinical trial to prevent secondary heart attacks. Investors have given CSL the mandate to invest rather than reward them with hefty dividends ... The factor that sets CSL apart from its peers among the largest five Australian companies - BHP, the Commonwealth Bank, Rio Tinto and Westpac - is that investors are not buying into it to chase dividend yield ... based on Wednesday's share price of \$233, the yield is a relatively paltry 1.15 per cent."*

### **On these quality growth stocks, the yield never looks attractive**

As an investor, I never chase current yield. It is income over time I am looking for. Yield is an abstract obtained by dividing two dollar values, the most recent dividend and the current share price. Thus, this abstract is hostage to movements in either one or both of these numbers.

CSL, like a number of other successful companies such as Cochlear and Credit Corp for example, are low yielding for the simple reason that as the profits and dividends grow, the share price goes up. Because of the phenomenal growth in share price (a result of the phenomenal growth in profits) when you divide the dividend into a rising share price, the yield never looks attractive.

Added to this, the success and strong dividends associated with these three companies ensures that the price is at a premium which naturally puts downward pressure on the abstract yield. However, unlike the journalist, you should never assume that the low yield is an indication of low dividends and therefore low income.

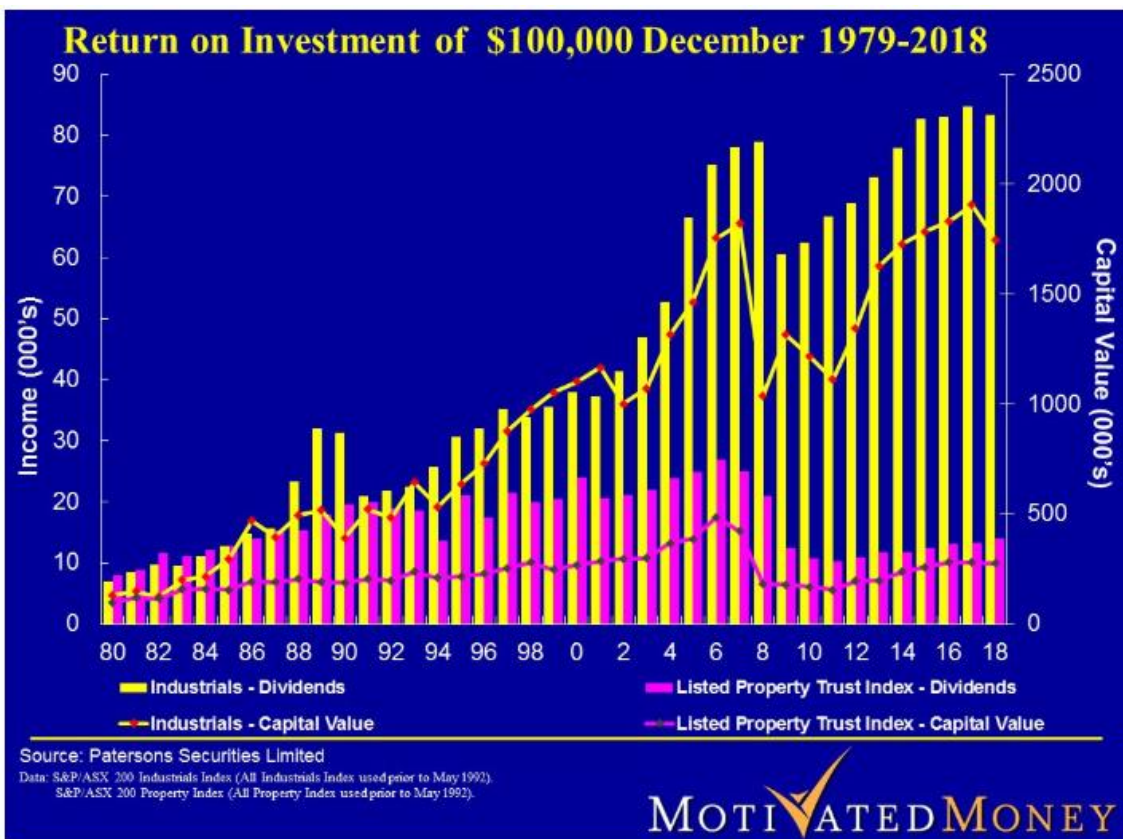
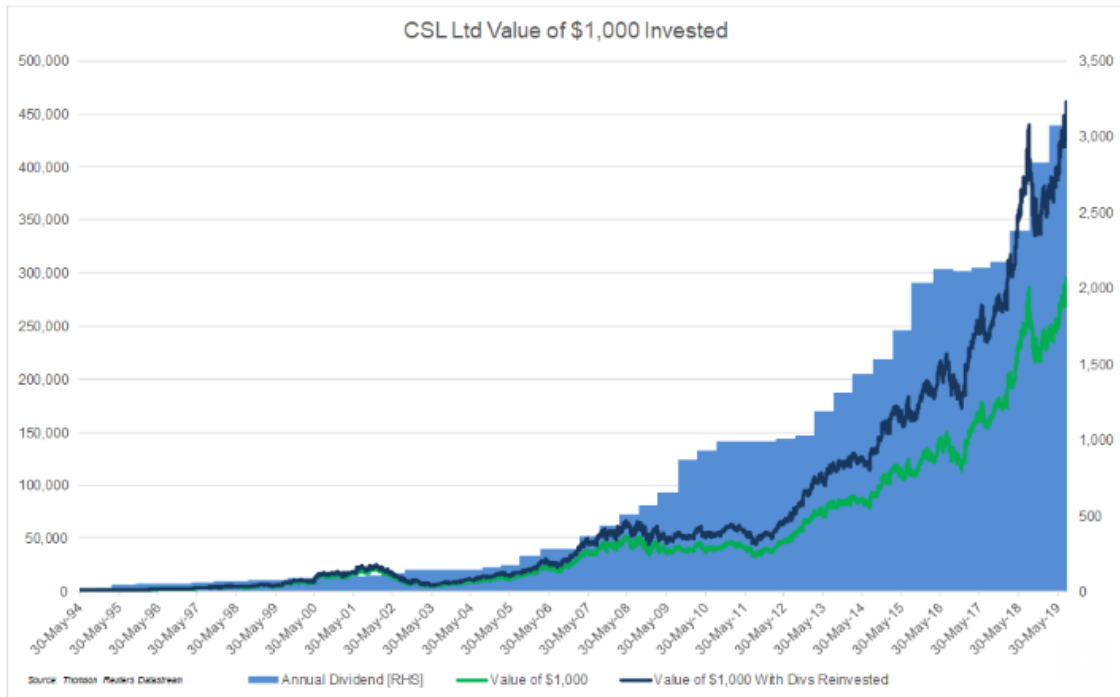
The three shares mentioned, despite their low yields, have produced an extraordinary income stream.

Credit Corp (ASX:CCP) is my favourite example. Since 2000 we have invested a total of \$137,000. Our CCP shareholding is now worth \$1.8 million. It sits on a paltry yield of 2%. Why so low? Because the share price has risen at the same stratospheric rate as the dividend. The good news for us is a current 'yield', as I judge it, the last dividend divided by amount invested, is 33%. If that isn't enough, total dividends paid since 2000 now stand at \$290,000, a return of more than 200% (not adjusted for inflation) on our capital in income alone.

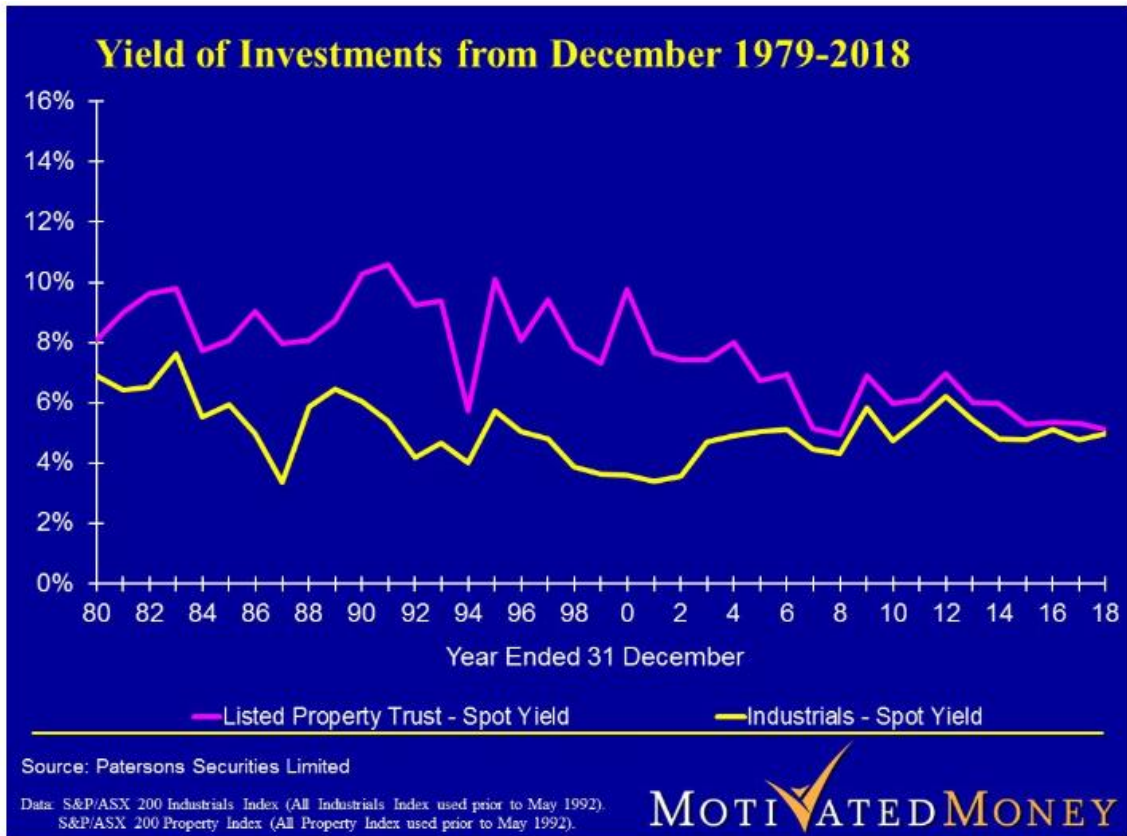
The same applies for CSL. The following Chart 1 (next page) shows the extraordinary growth in both share price and dividends that CSL has bestowed upon its shareholders since 1994.

### **Ignore the spot yield quoted by many**

Consider the listed property trust sector, now commonly called A-REITs (Australian Real Estate Investment Trusts). Chart 2 (next page) compares the income from listed property trusts (S&P/ASX200 Property Index) to the dividends from industrial shares (S&P/ASX200 Industrials Index) since 1979. Clearly the shares produce a far superior income over this long term. This is why I have often written about the long-term merits of industrial companies for income versus nearly every other asset class.



Now consider Chart 3 below plotting the yield of these two sectors over the same period. There can be no doubt that property is a far superior investment for those seeking yield. Ever since I returned to Australia in 1988, I have had people, particularly retirees, telling me that property was a far better income investment than industrial shares because of its superior yield.



The reason the yield on property trusts is high is quite simple. As a result of their structure, they must distribute 100% of their income. Therefore, the vertical income bars (pink in Chart 2 above) represents a 100% payout ratio.

In contrast, the vertical yellow bars represent around 50% of the profits generated by industry. The corporate structure enables companies to retain profits without penalty for research and development, new technology etc.

**Think of current yield as an abstract**

The trap is baited by the fact that the yield is an abstract numeric (income divided by index value). If dividends remain stable and the share price falls, yields will rise. Conversely, if share prices rise, yields will fall. In Chart 2, the high yield of property is simply a function of the fact that the capital value line is well below the top of the dividend bars. Similarly, the industrials are low yielding because the value line is much closer to the top of the dividend bars.

Now, try and imagine the yield on shares if all companies, like listed property trusts, retained no earnings and paid out 100% of profits every year. If this happened, fewer people would buy property trusts for income rather than industrial shares.

Sadly, time and time again the yield word is used to describe income whilst the reality is that the link between the two is uselessly abstract. Experience has taught me that chasing the highest initial yield will almost certainly result in a worse income over the long term. Oh, and by the way, shares are not growth assets, they are income dynamos.

*Peter Thornhill is a financial commentator, author, public speaker and Principal of [Motivated Money](#). This article is general in nature and does not constitute or convey specific or professional advice. Share markets can be volatile in the short term and investors holding a portfolio of shares will need to tolerate short-term losses and focus on a long-term horizon, and consider financial advice.*

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## The top six checklist: is my SMSF on track and compliant?

Graeme Colley

With the never-ending changes to the super rules you may wonder whether your SMSF is OK or a renovation job is needed to get your fund up to date. Often all the noise about super can be confusing in trying to work out whether your fund is affected. This year there were lots of announcements about super, but few made it into legislation.

Here's a checklist under six major headings to review your SMSF and see whether it is on track. It covers the vital issues on setting up your fund, investing, obligations as trustee, compliance with the rules, paying benefits and preparing for an eventual exit.

### 1. Establishing the SMSF properly

When your SMSF was established did you do the following?

#### **Consider appointing professionals to help you set up your SMSF**

If you don't have the skills or experience to manage some features of your fund, you can always access an accountant, financial planner, SMSF administrator to help you. But remember it's the trustees who are ultimately responsible for running the fund.

#### **Choose individual trustees or a corporate trustee**

All members of your SMSF must be trustees of the fund or directors of a corporate trustee. If you are the only member of your SMSF you must have a second individual trustee or may have a second director of the corporate trustee.

#### **Appoint your trustees or directors**

The trust deed of your SMSF will provide information on how to appoint trustees. Appointment of a trustee may require another trustee's or member's approval.

#### **Create the trust and trust deed**

An SMSF is a special type of trust which is established under a trust deed which sets out the rights and obligations of trustees, members and others who have an interest in the fund.

#### **Check your fund is an Australian super fund**

If your SMSF is to receive the tax concessions available for superannuation, your fund must be established in Australia, important decisions about the fund are to be made in Australia and there are special requirements for overseas residents who wish to contribute to the fund.

#### **Register your fund with the ATO**

Your SMSF needs to be registered with the ATO soon after it has been established to qualify for the tax benefits that are available for super.

#### **Set up a bank account**

A bank account for your SMSF is very important as it allows the fund to receive contributions, make investments, receive income and pay expenses.

#### **Get an electronic service address**

If your SMSF receives contributions from an employer, it will need an electronic service address to allow the amounts to be credited to your SMSF's bank account.

#### **Prepare an exit strategy in case something happens to you or another member**

An exit strategy is important if it is necessary to wind up the fund due to benefits being transferred to another fund or the members being unable to manage the fund anymore.

### 2. Checking the investments

When you considered the fund's investments did you do the following?

#### **Prepare an investment strategy for your SMSF**

It is necessary that your fund has an investment strategy that considers the circumstances of the fund including investment risk, diversification and liquidity of investments as well as the member's situation.

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**Consider insurance for members**

Trustees are required to consider whether insurance should be provided for members as part of the fund's investment strategy.

**Confirm all fund investments comply with the super laws and are allowed under the trust deed**

SMSF trustees are required to understand the rules for the fund's investments as required by the super law and permitted by the fund's trust deed.

**Made provision to regularly review the investment strategy**

The investment strategy of your SMSF is required to be reviewed regularly at least annually.

**Document any decision about the investment strategy**

Investment decisions about the fund should be documented and approved by the trustees.

**3. Reporting accurately**

As an individual trustee of your fund or a director of the corporate trustee, do you know what you need to report and to who?

Has your SMSF met the following requirements?

**Value fund assets at their 30 June market value**

The superannuation rules require that the investments of your SMSF are valued at their market value every 30 June. Also, if you commence a pension or pay a lump sum from the fund a member's balance should be valued on the market value of the fund's investments.

**Pay any minimum annual income stream payments as legally required**

Making sure that you pay the minimum pension from your fund is important as it will allow any income earned by your SMSF on your pension account balance to be tax exempt.

**Obtain an actuarial certificate if required**

In some situations where your fund is paying a pension you may require an actuarial certificate which will tell you how much of the fund's income is taxable and tax exempt. Your accountant, tax agent or superannuation fund administrator can help you.

**Prepare the fund's end of year financial accounts and statements**

Each year your SMSF is required to lodge financial accounts, tax returns and regulatory returns. You are responsible for having them prepared and audited by a qualified professional.

**Appoint an approved SMSF auditor not more than 45 days before the SMSF annual return is due**

Your accountant or fund administrator can help you locate an approved SMSF auditor or you can access the list of approved SMSF auditors on the ASIC website at [asic.gov.au](http://asic.gov.au)

**Lodge your SMSF annual return by the due date**

Lodgement of your SMSF annual return with the ATO is something that your accountant or tax agent can assist you with.

**Lodge your transfer balance account reports if required**

When you commence a pension from your SMSF or convert (commute) the pension to a lump sum withdrawal your SMSF is required to report the amount to the ATO. Reporting dates depend on the total amount you have in super and your accountant, tax agent or fund administrator can help you there.

**Review the fund's investment strategy and document the review**

Your fund's investment strategy is required to be reviewed regularly, which is usually on an annual basis. Make sure if there is no change to the strategy you have kept a minute in the fund records confirming that you have reviewed the strategy.

**Maintain all fund records as required under super laws**

The super laws require you to keep books and records about your super fund. These are usually stored electronically and include the fund's accounts, legal documents and trustee decisions. However, there are some books and records that need to be retained for at least 5 or even 10 years even after your SMSF has been wound up.

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#### **4. Keeping the fund's tax concessions**

If you wish to have the fund continue to receive tax concessions for contributions, investment income and paying lump sums or pensions, do you have a plan to ensure the following?

##### **You regularly review your fund's investment strategy**

Don't forget to review your fund's investment strategy at least annually.

##### **All fund money and assets are held separately from money and assets held personally by trustees or directors or by a related employer**

If you mix up your fund's cash and investments with your personal bank accounts and investments it not only makes it very hard to work out the member's benefits but it's a breach of the superannuation laws.

##### **All fund investments comply with the super laws**

While the super laws allow your fund to invest in a wide range of investments don't forget that there are many rules in place to ensure you maintain your SMSF to provide benefits for members and dependants. If your SMSF makes loans to member, invests or lends too much to anyone who has a relationship with the fund, for example, you or your SMSF could be penalised for any breaches.

##### **All contributions received by the fund are allowed under the super laws**

If your SMSF is to accept contributions from employers, members or anyone else make sure the fund can accept the contributions as permitted under the super laws. These rules are simple to understand, however, once a member of your SMSF reaches 65 there may be limits on the types of contributions that can be made to the fund.

##### **All benefit payments made by the fund have been made in accordance with the super laws**

If you are going to make a payment from your SMSF as a lump sum or pension, make sure the payment is made if a condition of release has been met. This permits the payment of benefits in many circumstances which relate to whether the member has retired, is 65 or older or may be invalided. It also includes the payment of death benefits to your dependants on your death or paid as provided in your last will and testament.

##### **Proper and accurate records have been maintained as required**

Keeping proper records can help you when it is time to prepare the fund's accounts, calculating member's account balances or when it's time to pay benefits to members, dependants or to your estate. You may have delegated this responsibility to other professionals who can advise you on the types of information they'll require to prepare your SMSF's accounts.

#### **5. Paying pensions**

If your fund is paying pensions or about to start paying pensions, did you consider doing the following?

##### **Get advice from an SMSF professional**

An SMSF professional will be able to provide you with strategies that ensure pensions are paid as required by the super laws and tax is managed in the best possible way.

##### **Check your SMSF trust deed to make sure it allows payment of the income streams**

Your SMSF's trust deed and other governing rules is important as it provides information on the responsibilities of trustees and members. Before you commence paying pensions to members make sure they are paid as authorised by the trust deed. There are many stories in the courts where the payment was not correctly authorised.

##### **Confirm the member qualified for payment of the pension**

Prior to paying a pension to a member or dependant from the fund make sure they are entitled to receive the benefit by meeting a condition of release.

##### **Obtain an actuarial certificate if required**

In some situations where your fund is paying a pension you may require an actuarial certificate which will tell you how much of the fund's income is taxable and tax exempt. Your accountant, tax agent or superannuation fund administrator can help you.

##### **Value the assets that support the income stream at market value**

If you commence a pension or pay a lump sum from the fund a member's balance should be valued on the market value of the fund's investments.

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### **Determine the minimum annual payment required under super law (and the maximum annual amount for a transition to retirement income stream)**

Making sure that you pay the minimum pension from your fund is important as it will allow any income earned by your SMSF on your pension account balance to be tax exempt. If your SMSF is paying transition to retirement pensions to members make sure you limit the payments within the minimum and maximum limits if it is not in retirement phase.

### **Register for PAYG withholding if required**

Sometimes pensions and lump sums paid from your SMSF may be taxable, especially if you are under 60 or where death benefits are paid to your adult children. If that's the case, then the fund may need to be registered for PAYG purposes and tax withheld. Your accountant, tax agent or fund administrator can help you with registration and the amount of tax to be paid.

### **Determine your event-based reporting timeframe if required**

When you commence a pension from your SMSF or convert (commute) the pension to a lump sum withdrawal your SMSF is required to report the amount to the ATO. Reporting dates depend on the total amount you have in super and your accountant, tax agent or fund administrator can help you there.

## **6. Setting an exit strategy**

You may not think it, but even when you start your SMSF you need to include an exit strategy plan just in case something unexpected happens to you or another fund member.

Your plan may include:

- Checking the trust deed for information on winding up the fund
- Paying out or rolling over all your super benefits (leaving enough to pay final tax or expenses if required)
- Appointing an approved SMSF auditor to complete the final audit
- Completing and lodged the final SMSF annual return (including wind up details)
- Lodging your transfer balance account report if required
- Paying any outstanding tax, or
- Closing the fund's bank account after the ATO confirms the fund's ABN is cancelled.

There are many aspects to making sure your SMSF runs like a well-oiled machine, but the main thing is keeping your super in the best condition possible so it can look after you in retirement.

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*For more articles and papers from SuperConcepts, please click [here](#).*

## **How currency exposure is part of managing risk**

Gofran Chowdhury

In the past decade the value of the Australian dollar has dropped more than 35% against the world's most important currency, the US dollar. Since the start of 2018 the Australian dollar has declined 18%, a significant enough fall to have real impacts on investments and prices.

A clear impact is on travel. If you were planning to buy US dollars for your travel needs a decade ago and converted A\$5000, you would have received about US\$5,350 in your pocket. Today, those same savings will only be worth about US\$3350.

### **Your exposure to currency**

The direction of a currency has other significant impacts unrelated to travel yet important to your purchasing power and even your overall wealth. For instance, we purchase a lot of overseas goods, including food, cars, fuel, clothing and electronics.

When our dollar is down, retail prices for those goods tend to rise, as importers usually pass on the added costs to end customers.

The ebb and flow and interdependence of global trade has made foreign exchange the world's largest financial market, with more than \$US5 trillion a day worth of currency exchanged. In Australia, nearly \$120 billion of currency changes hands every day and its growing rapidly.

There are several factors driving forex growth in Australia, including increased inbound and outbound travel, a growing number of foreign students undertaking study in Australia, and new migration.

Given the sheer size and pace of growth in this market, it is surprising that more Australians are not attuned to the implications of currency movements on their hip-pocket.

**How can you do more with your cash?**

Australians hold a large portion of their wealth in cash and, not surprisingly, specifically in Aussie dollars.

When investors do this, they expose their portfolio to substantial downside risk.

A portfolio, with only Australian-focused assets, is dependent on the outlook for the local economy. If our economy has a downturn, a localised portfolio will take a similar or even greater hit.

Currently, this risk is heightened, with the outlook for the Australian dollar uncertain because of low wage growth, low inflation rate, a softened housing market and issues relating to trade wars and markets.

By holding different denominations in overseas currency and investments in a portfolio, investors can spread risk across different geographic regions.

This can potentially smooth out investment returns over the long term, as Asia, the US and Europe will follow divergent growth paths.

During the GFC, for instance, when developed countries saw their growth downgraded, Asian economies scraped through relatively unscathed.

A currency's importance in the global economy will also determine how it's affected by internal and external events. The US was one of the countries hardest hit by the GFC and yet its dollar actually appreciated.

From the peak to the lowest level during the GFC, the ASX dropped **-54%**. Over the same period USD/AUD was up **+45%**



As the globally-recognised reserve currency, the US dollar is what's known as a 'safe haven' currency, meaning people buy it if they are uncertain of the direction of less globally-important currencies, like the Australian dollar.

So money often flows into US dollars in times of uncertainty. Even if the US economy suffers a shock, the US dollar can still remain strong.

This compares with the Australian dollar, which can be sold off aggressively in times of risk.

The Aussie dollar's value is tied to its dependence on the export of minerals, gas, agriculture and bulk commodities, such as iron ore, bauxite and coal.

### **Earnings on cash**

The cash rate is another factor to consider when looking at currencies. If we look to next year, if you hold Australian dollars in 2020, the cash rate may be around 0.50%. If you hold US dollars in 2020, the cash rate may be around 1.50% to 1.75%. Both of these levels factor in a further two predicted rate cuts in Australia and the US.

While holding cash in different currencies may seem difficult, recent digital advancements have made this a relatively-straightforward option for ordinary Australians. Locally, international banks and fintechs have good options for customers to keep their money in a variety of currencies.

However, people still need to do their research to ensure they are choosing an option that best suits their needs, paying particular attention to any hidden fees.

Depending on the situation, this could just relate to holding currency or perhaps doing more with it such as buying foreign currency bonds. We are seeing a trend among our high net worth clients where they are buying US\$ as a safety proxy, and then investing in high quality US dollar bonds. Year-to-date, we've seen a 36% increase in US\$ bond purchases.

For investors and savers alike, managing currency exposure within a portfolio is an important part of a wealth management plan. It can both protect and enhance returns while improving risk management.

*Gofran Chowdhury is Head of Investment Specialists at [Citi Australia](#), a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any individual.*

*For other articles by Citi, see [here](#).*

## **Managing LIC discounts and premiums**

Peter Rae

Over the course of the last 12 months we have seen discounts to NTA grow wider in most of our Listed Managed Investment (LMI or sometimes called Listed Investment Companies or LICs) coverage universe and, where they existed, premiums have narrowed or turned into discounts. Even LICs which have seen their shares trade at 20%+ premiums to NTA over the past few years, such as WAM Research Limited (ASX:WAX) and WAM Capital Limited (ASX:WAM), have seen their premiums to NTA contract to the smallest levels in many years.

### **Discounts can persist**

This waxing and waning of premiums and discounts has been part and parcel of LIC investing for many years. This can provide opportunities for investors but also make it difficult for investors to gain access to quality LICs trading at premiums. We note that WAX and WAM have traded at persistent premiums for many years and those looking to buy into the shares at NTA, or even better a discount, have been left in waiting.

Other names have traded at persistent discounts for many years with no end in sight despite, in some cases, solid underlying portfolio performance. The existence of these persistent discounts has led to corporate activity in the LMI sector with takeovers and mergers and more recently the windup of LIC's such as 8IP Emerging Companies (ASX:8EC). We have also seen the restructure from a LIC to an active ETF vehicle in the case of Monash Absolute Investment Company (ASX:MA1).

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## Price control mechanisms

Despite the launch of on market and off market buybacks to try and control and narrow persistent discounts, we have not yet seen the introduction of explicit discount control mechanisms in the Australian market. These mechanisms are relatively commonplace in the UK Investment Trust (IT) space which is equivalent to the LIC space here in Australia.

A standard example would be that when a company's shares trade at for example a greater than 10% discount to its NTA, this immediately triggers an on-market buyback by the company. Similarly, if the shares trade at a greater than 10% premium to its NTA the company would issue shares into the market at NTA. The logic behind this strategy is that as the discount control mechanism is clearly articulated it helps to keep the share price trading around its NTA as there is a clearly defined mechanism and course of action to be followed in case the share price moves well above or below the NTA. The band around which the share price can deviate from the NTA before the mechanisms are activated are set by the board and can be as tight or as loose as deemed fit given the underlying assets in the company.

While discount control mechanisms are not the panacea for persistent premiums and discounts, evidence from the UK market would suggest they can help alleviate such large divergences from NTA and allow investors to trade in and out closer to NTA the majority of the time.

We note that many Australian LICs do have the ability to use buybacks as part of their capital management and a number of buybacks are currently in operation. Despite this, many continue to trade at large discounts to NTA with the buybacks often ineffective in reducing the discount. Continued buyback of securities will also lead to a reduction in fund size and may not be of any real benefit to LICs that are already subscale.

With AGM season fast approaching for the vast majority of LIC' in October and November, the issue of persistent discounts, along with potential strategies for addressing the discounts, is something that LIC shareholders can raise with Boards at the AGM.

We continue to expect further consolidation in the sector and other forms of corporate action designed to address both the issue of scale and persistent discounts.

For further updates on LICs, see the latest IIR Report for [September 2019 here](#).

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## How the S-curve helps to find winners and losers

Nick Griffin

There's always consistent noise on the macro-economic environment at any stage of the investment cycle. Currently, negative interest rates, volatility and international political affairs such as Brexit and the US-China trade war are the main talking points.

These macro-economic issues do impact market sentiment, especially in the short term, and investors often believe they need to come to grips with them in order to make the right investment decisions.

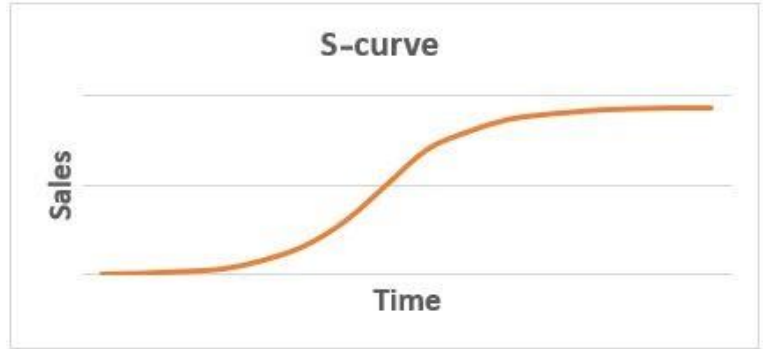
### Structural growth more important than macro trends

While being cognisant of the prevailing market, at Munro Partners, we take a longer-term view. The macro picture isn't the key to investment success. Instead, it is structural growth that will deliver the strongest returns over the long term, regardless of the economic backdrop or point in the cycle.

As a growth manager, we are looking for structural growth opportunities and identifying and investing in the winning stocks. Earnings growth drives stock prices, sustained earnings growth is worth more than cyclical earnings growth and markets will often misprice growth and its sustainability.

Another way of describing this is the ability to identify S-curves.

In business terms, the S-curve tracks how a company or industry grows over its lifecycle. There comes a point in the lifecycle when growth inflects, driven by a structural change. It is the tailwind created by the structural change that assists a company to deliver and create wealth. The resulting graph looks like an elongated 'S'.



Looking at the S-curve can help investors work out where a company or industry is on its structural transition, or growth trajectory.

**Examples using the S-curve**

Digital payments is a good example, and one that most people can relate to. In Australia, many people have gone from using cash 100% of the time to approximately 30% in their day-to-day transactions, and instead using cards or mobile phones to 'tap and go'.

Translating this to an S-curve, it means that people started using cards, just occasionally at first and then, as cards got easier, they started using them a lot more.

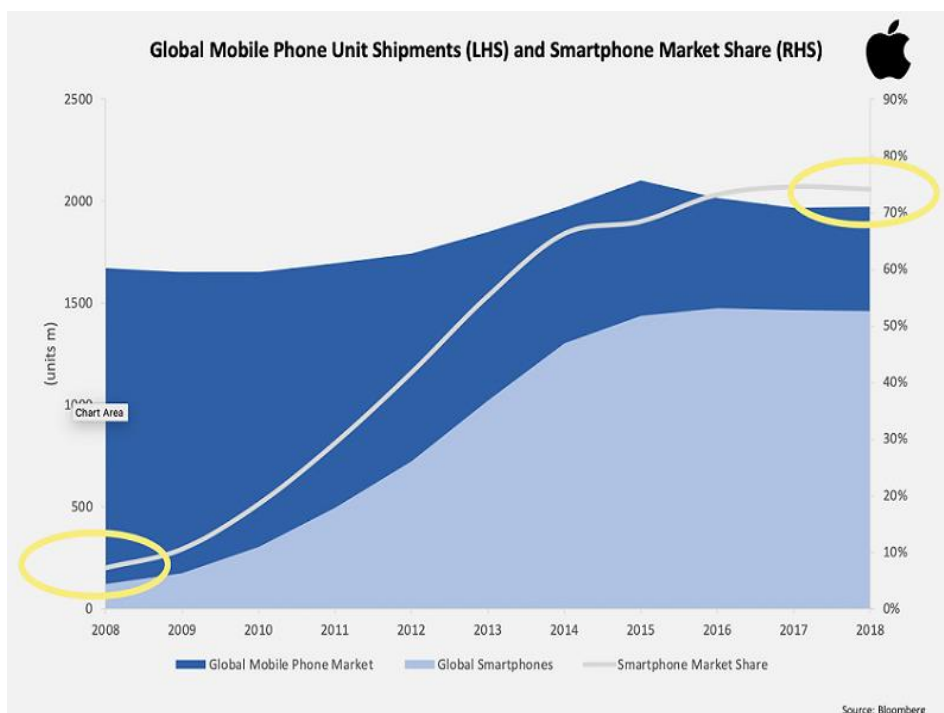
The network effect is evident: more people making digital payments, leading to more merchants offering digital payments, leading to easier to use digital payment technology, leading to more people making digital payments – and so on. This is how the S-curve first kicks up and continues at an increasing pace.

According to Visa, penetration in Australia is the second highest in the world for tap-and-go payments (after Sweden). Around 90% of face-to-face transactions here are now tap-and-go, and that’s happened in the space of about four or five years. So Australia is at the top of the S-curve, where growth is tapering off.

However, looking globally, the opportunity is still significant. The US, for example, is currently below 10% for tap-and-go payments. Meanwhile, the global average is around 50%. Looking at all the main providers (Visa, Mastercard, PayPal etc), we would estimate that they are approximately 40% through their S-curve, and future growth is still sizable.

Of course, the S-curve trajectory does run out. Smartphones are an example of this.

A decade ago, smartphone penetration was virtually non-existent, and the mobile phone market was dominated by names such as Blackberry, Motorola, Eriksson and Nokia.



Today, over 80% of people with a mobile phone, have a smartphone, and the clear majority of these in developed nations are either Apple or Samsung. Blackberry and its ilk have all but disappeared from the mobile phone market.

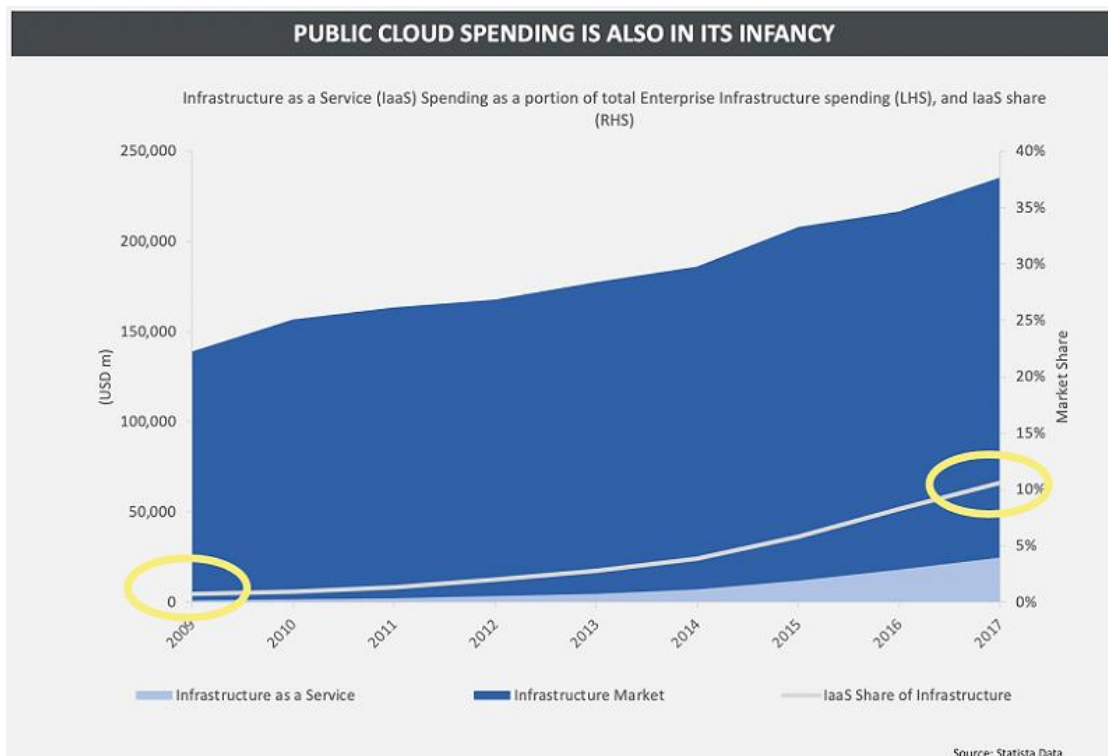
However, the smartphone market has now stopped growing. Apple is currently relying on price hikes and its services revenue for growth, not new customers for its products.

We seek to work out the size of the market, the size of the structural opportunity, and where we are in that structural opportunity i.e. are we at the start, the middle or the end of the S-curve?

We would argue that the S-curve always beats the macro when it comes to investing.

### Opportunities for investors

One industry that exhibits the beginning of the S-curve is cloud computing and the shift to software as a service.



We see this as a great opportunity. Globally, IT spending grows at around 1-3% per annum, split into software, hardware, IT services and data centres, as the four main components.

But the spend on IT has changed dramatically in recent years.

Businesses don't need to buy a server anymore, because they can host all their information and data in the cloud. They don't need to buy IT support anymore because they're buying software as a service through the cloud. And they don't need to spend as much on hardware because they don't need as much equipment. It's almost possible to run a business off a smartphone.

While big companies like Microsoft and Amazon have been significant beneficiaries of this trend, we believe there is also scope for smaller high growth software companies to come along and dominate their areas. As a few examples – Adobe dominates the media suite area; Salesforce does CRM; and Atlassian is the go-to provider for developers.

These companies are creating their own network effects globally, just as we saw previously with Google or Facebook.

Their stocks are highly valued but we believe they are still not valued correctly because of the network effect and cash generation capacity as they go through this structural shift.

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## Picking the trend

Investors also need to ensure they understand the difference between picking the trend and picking the winner.

There's nothing worse than getting the structural trend right but picking the wrong stock. For example, identifying the potential for Android phones but investing in HTC 10 years ago instead of Samsung.

Another good example is streaming TV. The thesis is that streaming TV will replace linear TV over a period of time, and most people would probably agree with this. So we are on the S-curve of streaming adoption.

However, many people are talking about who will be the winner in the space and whether Netflix will continue its success story. But the loser here is not Netflix vs Disney vs Amazon. The loser is linear TV channels, all around the world. Many of them will cease to exist in the next decade, if the thesis is correct. And the winners are the companies that provide quality streaming services.

Not every company will succeed, but the key to success is being able to identify the few winners that will succeed from the structural growth tailwinds, regardless of the macro-environment.

*Nick Griffin is a Founding Partner and Chief Investment Officer of [Munro Partners](#). This article is for information purposes only and does not consider the circumstances of any investor.*

## Central banks risk losing their feted 'independence'

Michael Collins

William Martin is the longest-serving Federal Reserve chief, serving from 1952 when Harry Truman was President to 1970. A few years into the role, Truman saw Martin on a street. The President from 1945 to 1953 stared at Martin, called him a "traitor" and walked away. Martin's betrayal? He prioritised a successful fight against inflation, then running at an annualised 21% in 1951, rather than help Truman fund the Korean war by ensuring Washington could borrow at 2.5% or less.

### US Presidents versus the Fed

Lyndon Johnson, the fourth of Martin's five Presidents, got frustrated with him too. Johnson enacted fiscal stimulus in 1964 only to see the Fed resist his bullying to keep interest rates low. In 1965, Johnson summoned Martin to his Texas ranch where the President "shoved him around his living room, yelling in his face: 'Boys are dying in Vietnam and Bill Martin doesn't care.'" When Martin's final term ended, inflation was 6% and heading to double digits.

Now President Donald Trump is treating the Fed with similar disrespect. Trump has publicly criticised the "going loco" Fed led by "clueless" "enemy" Jerome Powell about 50 times since mid-2018. The worry is that Trump is just another menace to the practice whereby central banks set monetary policy to meet inflation and other targets supposedly free of political pressure.

Bloomberg counts that 17 central banks faced political interference in 2018.

Many forces are combining to weaken the autonomy of central banks, such as:

- Populists are targeting central banks because the GFC discredited the neoliberal framework of which their independence is a part.
- Central banks have been given more tasks, often bank supervision, that come with controversies.
- Central bankers are commenting on politically sensitive topics such as climate change and gender quotas.
- Their asset-buying programs have boosted inequality by inflating asset prices (even when conceding such tactics staved off recessions).

But two other reasons stand out that point to the trend intensifying because they relate to the merits of independent monetary policy as a way to manage economies.

The **first** is the raison d'être for independent central banking is waning; low inflation means politicians have lost their incentive to outsource the blame for higher interest rates.

The **second** is that orthodox monetary policies are exhausted, and people realise monetary tools can't be radicalised much more because they promote risks, namely, they inflate asset prices, hinder lending and squeeze bank profits (which increases the risk of financial instability). To overcome this failure of monetary policy to fire sustainable growth, policymakers are pondering fiscal solutions that would dilute the autonomy of central banks.

Japan's experience shows how political and economic conditions can force action that curtails central bank freedom. Many argue the Bank of Japan lost its autonomy in 2013 when it became part of Prime Minister Shinzo Abe's drive to refloat Japan's deflation-ridden economy. A central feature of 'Abenomics' is it blurs the distinction between monetary and fiscal policies, which were separated to stop the inflation-prone practice whereby central banks bought government bonds directly from Treasuries to fund fiscal deficits.

### **Central bank autonomy**

As Japan's fight against deflation shows, the weakening of central bank autonomy can be an appropriate policy response. But the loss of autonomy could come at a cost, especially if it's judged to be due to political pressure rather than economic circumstances. The belief that central banks were above the political fray reduced the level of uncertainty in asset prices and instilled public faith that inflation would stay tame, fiat currencies would hold their worth and central banks would act for the common good. If central bank autonomy were to erode, such investor and public confidence could be hard to restore.

To be sure, most central banks only enjoy a 'quasi independence'. Central banks are entwined in politics because they form part of the executive and they often cooperate with Treasuries. Lawmakers set goals for central banks that can be revised any time. They make central bankers report to parliaments. Many central bank leaders need to maintain public and parliamentary support to ensure their reappointment. The record of 'apolitical' central banking has blemishes. The biggest are the global financial crisis and the ECB's rate increases of 2010 that intensified the eurozone debt crisis.

Whatever their errors or the degree of autonomy, granting central banks independence was an apt political and policy solution when inflation was a threat. Today's low-inflation, low-growth and high-debt world will likely call on fiscal remedies that erode central-bank autonomy.

As policymakers turn to fiscal policy and executive fiat to promote sustainable more-equitable growth, central bankers might morph into public servants whom Truman would consider loyal and to whom Johnson would be friendly. But investors and the public might trust them less, especially if the loss of autonomy occurs while Trump is tweeting against the Fed.

*Michael Collins is an Investment Specialist at [Magellan Asset Management](https://www.magellangroup.com.au/insights/), a sponsor of Cuffelinks. This article is for general information purposes only, not investment advice. For the full version of this article and to view sources, go to: <https://www.magellangroup.com.au/insights/>.*

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## **Has FoFA become the Failure of Financial Advice?**

Graham Hand

The Future of Financial Advice, or FoFA, reforms came into effect on 1 July 2013. They imposed a ban on conflicted remuneration and required financial advisers to act in the best interests of their clients. Existing commission arrangements were grandfathered, and looked like staying until the Financial Services Royal Commission tore them down.

This week, the final nail was hammered into the grandfathering coffin. The Treasury Laws Amendment (Ending Grandfathered Conflicted Remuneration) Bill 2019 passed in the House, banning conflicted remuneration paid to financial advisers from 1 January 2021.

However, the advice industry has not found another business model that allows average Australians to receive comprehensive financial advice. It is right that conflicted advice should be stamped out, but if most people now cannot access detailed and personal services, then we have fixed one problem and created another.

### Why is full-service advice expensive?

I recently asked a financial adviser who services older, high-end clients about her first question at an initial meeting. "Tell me about your family," she replied. Not money or assets, but a person talking to a person about their family, life and goals. And there is the affordability dilemma. Comprehensive financial advice takes a lot of time. A full Statement of Advice (SOA) runs over 100 pages and the need to review all circumstances and develop a plan takes 10 to 15 hours and costs between \$3,000 and \$5,000 depending on complexity.

But focussing only on the SOA overlooks a bigger point. There is far more to a comprehensive relationship than an initial document. The Financial Planning Association (FPA) identifies six steps in the advice process:

1. Defining the scope of the engagement
2. Identifying the goals
3. Assessing the financial situation
4. Preparing the financial plan
5. Implementing the recommendations
6. Reviewing the plan

An added complication is that most financial planners offer an initial meeting for free. Business development takes a lot of time and expertise. The adviser must write a proposal to a potential client stating how much the advice will cost and what will be involved without knowing if the client will pay. It's often a loss lead to win the business.

The first year of working with a client takes more like 35 hours which limits the number of clients a new adviser can accept. The cost of 35 hours at \$300 an hour is about \$10,000. A financial advice group that charges an ongoing fee of 1% of the portfolio (usually a declining percentage for large balances) requires \$1 million to earn \$10,000 for full-service advice. Most people do not have \$1 million. Other groups are moving to a charge a percentage of income as it is more labour intensive.

The recent ASIC survey results in '[Financial advice: what consumers really think](#)' found:

*"Perceiving financial advice as too expensive was the most commonly identified reason for not seeking advice. Overall, 64% of all the online survey participants agreed that financial advisers were too expensive."*

The most common reason for not seeking advice were (multiple answers allowed):

Financial advice is too expensive	35%
My financial circumstances are too limited for it to be worth getting financial advice	29%
I like to manage my finances by myself	26%
I do not trust financial advisers	19%
I do not see the value of consulting a financial adviser	18%

Metlife recently reported it costs \$5,000 for an adviser to complete a risk insurance plan, but consumers are willing to pay only about \$1,200 in up-front fees. A leading boutique advice CEO told me their minimum fee is \$6,000 a year, and this gives only a basic service of one meeting a year. Another CEO said high touch is now reserved for clients with over \$2 million, mid touch is from \$750,000 to \$2 million and low touch is sub \$750,000.

At the latest Association of Financial Advisers' National Conference, EQ Wealth Director Simone Du Chesne, said:

*"I find it incredibly ironic that accessing financial advice has become the privilege of the middle class and that those who may need it most or just as much as any other Australian are not able to afford to see an adviser ... While I appreciate and support the need for operating in a compliant manner when providing advice, I believe the paperwork has become onerous."*

It's one of many consequences of the Financial Services Royal Commission. It identified the problem of conflicted remuneration without providing a mass market solution.

### Producing a financial plan

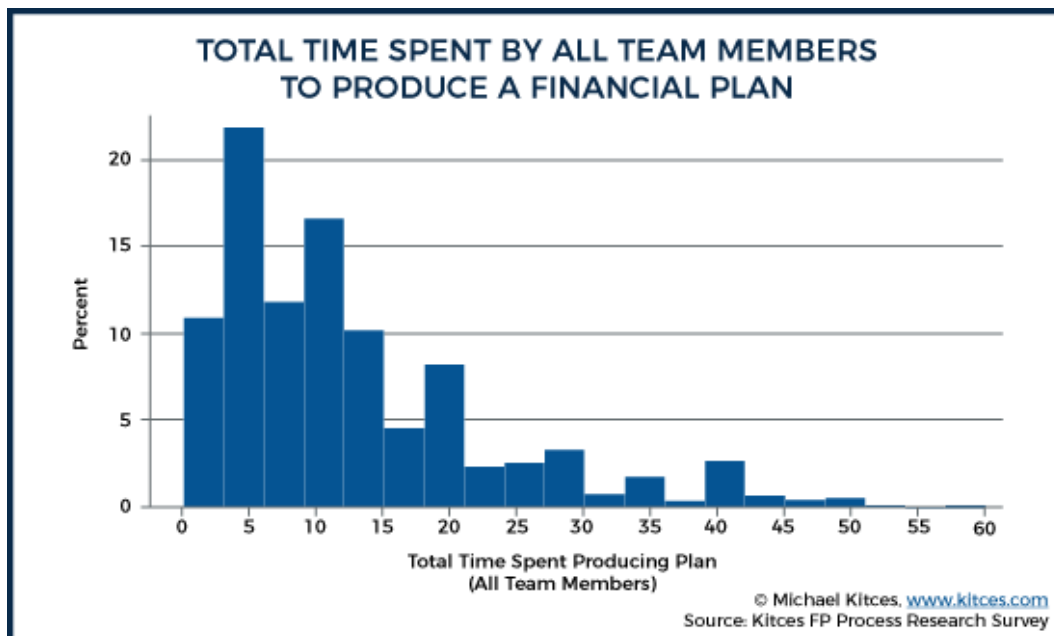
A 2018 FPA survey of its members found the average cost for an initial SOA was \$2,435. The average ongoing fee was \$3,354 per annum, taking the average cost to almost \$6,000 in the first year. Of course, there is a wide range.

Some advice firms are managing compliance by treating clients as 'wholesale', which removes the need to provide an SOA for a 'retail' client.

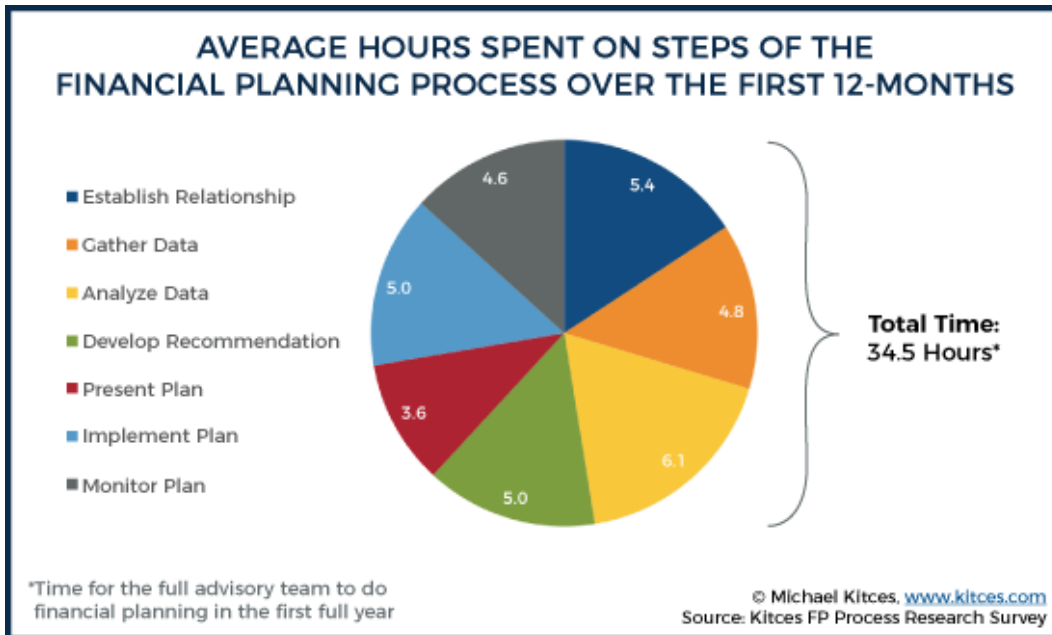
Kitces Research in the US have studied how long financial planning takes. I will assume the numbers are similar in Australia because there's little to suggest our regime is less onerous. Ask any financial adviser what they must do with a new client and their eyes will roll as they think about compliance, legal, best interests duty, conflicts, etc.

The Kitces article '[How Financial Advisers Actually Do Financial Planning](#)' provides details on how long they work and what they do. Notably, only 19% of time is spent meeting clients with 17% spent on business development. The most time-consuming part is designing financial plans and preparing for meetings with clients.

The following chart on time spent to produce a financial plan shows a median of 10 hours, but an average of 15 hours with a long tail due to some complex and time-intensive plans.

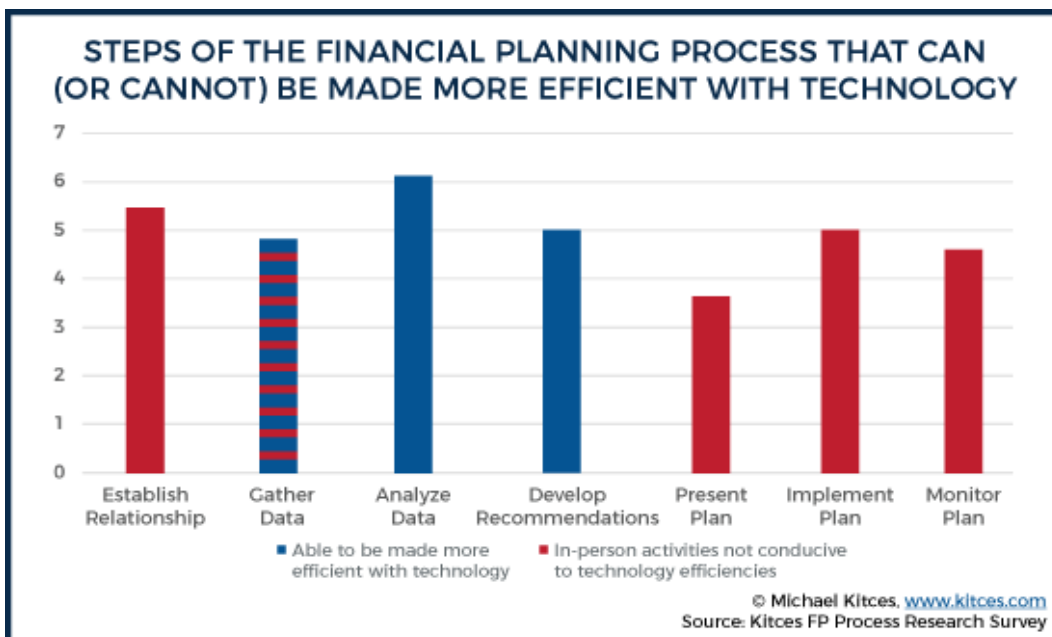


Similar to the FPA model, Kitces identifies seven steps involved in the first year of a relationship, and the chart below shows how this can consume the best part of a working week. In addition to these steps, depending on the structure of the adviser business, a good chunk of extra time is taken simply running the business. It doesn't leave much space for new clients, which is why the industry believes there will be a shortage of advisers as new education standards hit in coming years.



**How much will technology assist?**

Surely, this is where adviser technology and software come in. Here is Kitces’ most significant insight. The majority of the financial planning process involves client meetings and activities which technology has limited scope to replace. In the following chart, only the blue steps can be made more efficient with technology, and there’s a lot more red.



The steps of gathering and analysing data and developing recommendations are number-crunching processes which technology can improve. It can’t help much with client conversations, discovery of goals, a deep understanding of risk appetite beyond some simple tests, and coaching the client in how to use a new plan. This is person-to-person stuff.

**The ASIC regtech solutions symposium**

I recently attended an [ASIC Regtech Financial Advice Files Symposium](#) where six providers of ‘regtech’ solutions were challenged to:

*"Demonstrate how technology can be used to help in determining the level of risk and regulatory compliance of financial advice based on a sample of client files in different formats provided by ASIC and any wider sample of client files or other related client profile and transactional data obtained independently by demonstrators."*

The six providers were Tiqk, GIRO by K&L Gates, IRESS, IBM, Flexprod and Advice Regtech.

Some impressive progress has been made in improving the efficiency of reviewing documentation for regulatory compliance, and it fits in well with Kitces' argument that certain parts of the advice chain can be improved by technology.

My brief summary of how regtech works for client advice files is that the technology scans the words and tables in financial advice documents to check for compliance with company policies, consumer obligations and best interest duty regulations. It aims to make internal compliance more efficient by flagging shortcomings against a series of lists. For example, it flags high-risk portfolios for extra review and scans for key words. It checks every file instead of the usual sample taken for audit purposes. Risk monitoring is improved with greater efficiency than the labour-intensive and error-prone exercise of humans scanning files.

At this stage of its development, it's only the start of a machine-learning and AI journey that makes marginal improvements in efficiencies. It is confined to checking and monitoring but this is a minority of the time spent by an adviser on a comprehensive plan. Anyone thinking regtech will fundamentally change the comprehensive advice process is in for a long wait.

As Daniel Crennan QC, Deputy Chair at ASIC, said in the introduction:

*"In order to improve risk management and minimise your compliance risks, you must include the capacity to explore, test, and implement 'compliance-by-design' regtech solutions within your business model. Obviously, none of us know what the future holds in this space. It's a learning exercise and none of us can doubt that technology is front-and-centre of financial services provision ... it would be ideal to witness a decrease in the number of ASIC's compliance-related enforcement actions as a direct result of industry's uptake of regtech."*

'Advisertech' is not limited to regtech, and other tools that might help advisers include enhanced financial planning software, the design of the investment platform, customer risk management and other office management tools.

### **What about digital advice (robo-advice)?**

This is not the place for a full review of Australian robo-advice, and we have covered the subject before, such as [here](#). The ASIC survey said:

- Only 1% of participants had used digital advice.
- 19% said they were open to it, once it was explained to them.

Digital advice is more accurately digital investing, matching an assessed risk appetite with a simple, diversified portfolio. There is a role for digital advice with inexpensive model portfolios matched to some measure of risk, that are easy to implement for certain clients. In fact, it's not dissimilar to the default option in a retail or industry superannuation fund, and costs about the same. Most Australians have a diversified fund at a cost of 60 to 100 basis points (0.6% to 1.0%) with access to a website, tax reporting and general advice.

But it's not comprehensive financial advice. It can't tell someone if they should invest or pay off their mortgage. It does not consider social security, super contributions, pensions, estate planning, insurance and a range of other issues good advisers now specialise in such as goals-planning and lifestyle coaching.

The leading robo-advice businesses in the world have morphed into a hybrid model that includes contact with humans. Vanguard's Personal Advisor employs 1,000 financial advisers. At its heart, financial advice involves learning the goals and dreams of a client and coaching them in their unique circumstances, and most people want these discussions with an empathetic human.

### **Where is the advice industry heading?**

Full-service financial advisers with high net worth clients will continue to have strong businesses. Their clients are willing to pay, and if comprehensive advice costs at least \$10,000 as outlined by Kitces and the FPA, financial advice will increasingly become the domain of middle to upper income earners. At some stage,

technology might offer better solutions but if regtech progress is any guide, it's in the early stages of delivering marginal efficiency improvements.

For all the criticism by the Financial Services Royal Commission, much of it deserved, the vertical integration model where advisers were allowed to use in-house products, had the potential to serve the mass market. I explained here [how it could have worked](#), but the horse has bolted.

AMP's decisions on the future of its financial advice business point some of the way. In the face of the devastating blows from the Royal Commission, their commission-driven model is being dismantled. They can no longer provide comprehensive advice to most Australians. AMP will develop a model similar to industry funds which provides intra-fund advice without a comprehensive SOA. At the lower asset levels, the first touch will be a call centre or digital offer that will not be detailed financial advice and not seek to understand everything about the client.

It would be a mistake to underestimate where AI and machine learning may take the advice industry. Algorithms may one day listen to conversations and recommend a portfolio. Data should be easier to collect through sophisticated online registries and aggregation portals. Investment management is falling in price. However, most of the required automation is years away at best. In the meantime, the full-service offer will be reserved for the top tiers of clients willing and able to pay.

*Graham Hand is Managing Editor of Cuffelinks. The charts from Michael Kitces are used here with his permission and are taken from [this article](#), which gives more detail on his methodology.*

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