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FPA *Professionals* CONGRESS

BRISBANE 18-20 NOVEMBER 2015

FINANCIAL PLANNING
ASSOCIATION *of* AUSTRALIA

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Learning From

The Mistakes of Others

Goals of today's presentation

1. How to build resilience
2. How to reduce risk
3. How to engage in effective professional relationships

Case Study

Basic Details

- Mr and Mrs Client both age 56 with $500k in SMSF.
- Mr Client was assessed as a Growth investor for whom 80% Growth assets was appropriate
- Mrs Client was assessed as a Conservative investor for whom 30% Growth assets was appropriate
- Wanted to retire in 9 years on $60k pa income

Investment Advice

- Adviser determined that required capital at 65 was $1.2M
- Also determined that portfolio should be comprised of 90% Growth assets

Case Study

Sector	Asset Allocation Target in SOA	Target Amount	Asset Allocation - Actual	Actual Amount
Australian Shares	45%	$225,000	30%	$150,000
Overseas Shares	30%	$150,000	20%	$100,000
Property	15%	$75,000	40%	$200,000
Cash	5%	$25,000	5%	$25,000
Fixed Interest	5%	$25,000	5%	$25,000

Case Study

- SOA gave no explanation why $200,000 in property (40%) was recommended whereas the target asset allocation specified 15%;
- Property funds used were syndicates internally geared to 50%;
- Retirement projection did not include age pension;
- SOA did not discuss why 90% Growth assets were required;
- SOA did not contain a discussion of expected behaviour for the recommended portfolio;
- Allocation to defensive fixed interest sector was to be held in the Basis Yield Fund.

Case Study

<u>Issues with Advice</u>

- Recommended Investments did not match the target asset allocation and no explanation was given for the difference;
- Actual exposure to property sector was double due to gearing within the funds;
- The portfolio recommended with 90% Growth assets was in excess of the client's tolerance to risk and no warnings were given to the client;
- No discussion of expected behaviour was included to at least allow the client to make an informed decision about taking on more risk;
- Projection on which the capital amount of $1.2M was calculated was flawed as age pension was not taken into account.

Case Study

Performance of Portfolio

- From June 2007 to June 2010 (when they sold), Portfolio fell from $500K to $240K

Claim made

Loss of Capital	$260,000
Loss of Interest	$112,500
(7% pa compounded)	
TOTAL	**$372,500**

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Case Study

<u>Settlement</u>

- Determined that portfolio comprising 65% Growth assets was appropriate
- Performance of this portfolio (after fees) over same timeframe would have fallen by $90,000

Loss of Actual Portfolio	$260,000
less Loss of Appropriate Portfolio	$90,000
REAL LOSS	**$170,000**

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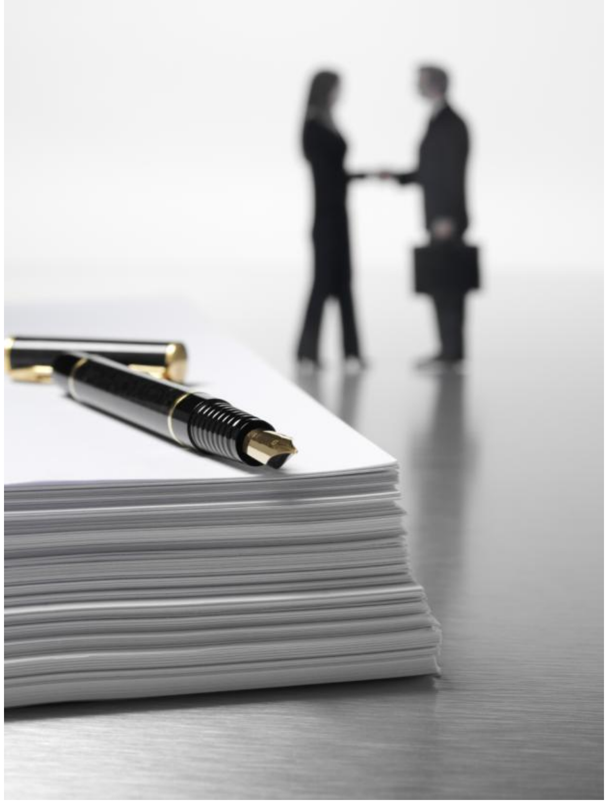
How to Prevent a Dispute



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Know your client

- File must evidence the client’s financial position
- Client’s objectives must be clear
- You must also show how you assessed the client’s tolerance to risk

- Above data needs to be in place at the time of each piece of advice
- Only need data that is relevant to the scope of the advice
- Gather enough data so you can have a basis for your advice

“*If it is not in writing then it hasn’t happened*”

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Risk Profiling

Risk profiling is made up of 3 components

1. Risk Tolerance of the client
2. Risk Capacity of the client
3. Risk Required for the client to meet their objectives

- You need to ensure all 3 areas are addressed

Risk Tolerance

Client's ability to sleep at night and not worry

- Major issue in many disputes
- It is a legal requirement you ensure risk tolerance of client is taken into account
- Risk profile questionnaire – not a legal requirement but they really help during a dispute
- If not using a risk profile questionnaire – the onus is on you to prove how you have tested the client's tolerance to risk

- If dealing with a couple – must assess or test comfort with both of them
- Need to ensure that what you are recommending to a client is consistent with their risk tolerance – and if not – why not

Risk Capacity

How well can a client absorb a loss

- Partly due to the amount of funds they have
- Partly due to investment timeframe

- For example - If a client is investing a sum of money for 1 year, their risk capacity is very very low

Risk Required

What level of risk does the client need to take to reach their goal?

What if a client has $10M and only needs $100,000 income per year?

<u>Practical Tip if risk required is low</u>

- Explain to the client that they can reach their goals with a very low risk strategy
- Explain the alternatives and gain their informed consent

Risk Required

What if Client has a low amount of capital and you calculate they need to take a high level of risk to reach their stated goals?

Practical Tip if risk required is high

- You must explain that the recommended strategy is outside client's tolerance
- Explain the alternatives – for example: work longer, reduce expectations
- Explain expected portfolio behaviour in relevant terms
- You must gain informed consent
- Your assumptions as to why the required risk is high will be rigorously tested

Know your product and your strategies

- Understand the likely behaviour of the products and strategies you are recommending
- Internal gearing in products must be understood
- An internally geared fund gives a client additional exposure to that asset class
  - for example $100,000 invested in a 50% geared fund gives a market exposure of $200,000
- Liquidity of products must be understood

- Independent research on a fund helps
  – beware that a high rating does not mean the fund is appropriate
- Be careful when recommending gearing
  – Double gearing, triple gearing, illiquid funds, margin loans

Set realistic expectations – clients will complain when expectations are not met

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Ensure your advice is 'fit for purpose'

- Show the client how your recommendations assist them in reaching their objectives
- All advice you give will be tested the same way – Buy, Hold, Sell
- Be very careful with review advice for existing clients

Best Interests requires advice to be likely to place client in a better position

Practical Tip

- Ensure the mix of assets is consistent with your recommended allocation
- If recommending gearing – prove client can afford it – ie cashflow
- Review the FPA Code of Professional Practice
- Review RG 175 – Seriously!

The best interest duty

ASSESS, DEMONSTRATE, DOCUMENT

- That client will be in a better position of they follow the advice

LIKELY FOS APPROACH – SOME KEY ELEMENTS

1. Safe Harbour steps followed – FPA Practice Standards 2- 4
2. Appropriate advice given – Is client in a better position (PS 4)
3. Any warnings for advice based on incomplete or inaccurate information (PS4 and 7)
4. Conflicts identified, managed and disclosed (PS 4 Rule 4.11 and PS 7)
5. Any other steps reasonably taken

Documenting Best Interest Advice - Consider

- ✓ Demonstrate you understand the client's circumstances, needs and objectives
- ✓ What you will and won't consider in the advice
- ✓ Your competency to provide the advice
- ✓ Research and recommendations on strategy and research
  - How is it appropriate to them, How are they better off as a result, what are the alternatives and why discounted
- ✓ If change in product or strategy
  - How does it fit with risk appetite, how does it help meet objectives, what's the strategy
- ✓ Outline risks, features, benefits, disadvantages and costs
- ✓ Risks – the amount they could lose, are they comfortable with the risk, are their alternatives
- ✓ Other reasonable steps taken – like short, medium and long term goals or when you will review
- ✓ Advice warnings
- ✓ Prioritising client interests

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Prioritising client interests

- Disclosing and getting consent won't be enough
- Identify, manage, explain and document relevant conflicts that either you or 3rd party have or avoid
- Document how advice meets goals and objectives to demonstrate putting client first
- Document reasoning behind recommendations to purchase, increase interest or change product so there can be no perception it benefits you

Avoid templated advice

- Template SOA for the ‘skeleton’ of the advice is appropriate
- Advice MUST be tailored to the client

- SOAs generally fail as they don’t explain the WHY

- WHY is the recommendation appropriate and how does it help client reach their specific objectives

<u>Practical Tip</u>

- Generic information should be in the appendices
- Use diagrams in your advice
- Use a simple executive summary

Disclosure of the risks of the advice

- Most product specific risks can be contained in the PDS but the SOA should refer to the PDS
- SOA will need to explain the following:
  - the risk of strategy - such as gearing, cashflow
  - the risk of the overall portfolio

- A client cannot make an informed decision unless you explain all the risks
- SOA must explain the pros and cons of the recommendations

- Disclaimers are of no use if the advice is not appropriate

Appropriate advice is not enough – you must explain the advice so you receive informed consent

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What should you keep in the file

- Client Data and Objectives – updated at time of EACH advice
- Information regarding risk profiling
- Filenotes
  - Nothing – this is a disaster
  - File-notes of discussions are better
  - Sending information to the client is better again
  - Signed acknowledgement they agree is the best of all

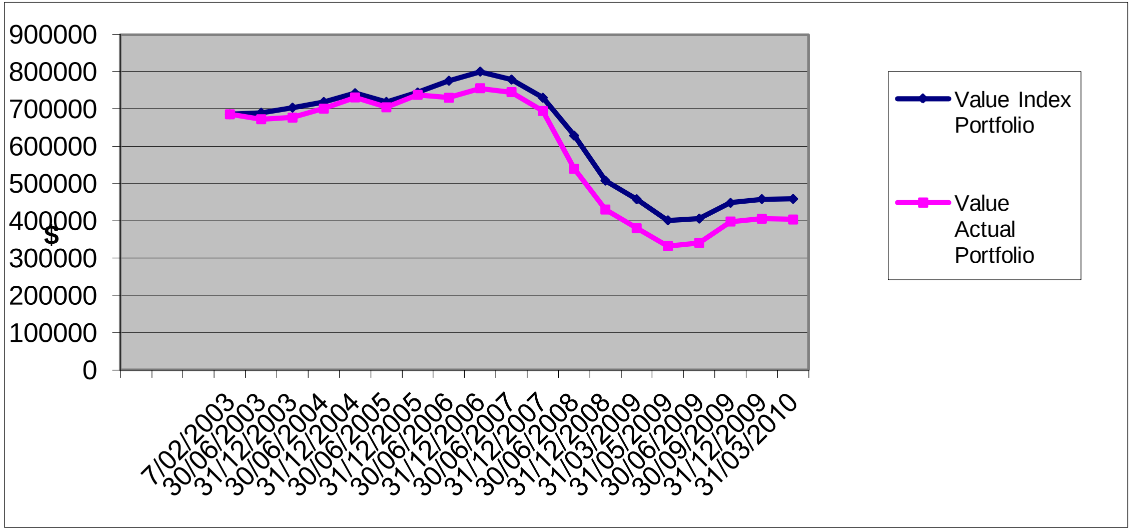
- Working Papers
  - show consideration of alternatives
  - show advice is tailored
  - show attention to detail

Dealing with a claim

- Goal is to stop the claim escalating
- Your PI insurer will need to be involved and may set the agenda
  - Don’t be tempted not to tell the insurer as this may give them a reason not to cover your claim
- Get logic involved and try to remove emotion where possible
- Most of the time it is better if the adviser is not involved in any meetings
- Set realistic expectations regarding timeframes – and meet them

Dealing with a claim

Diagrams to explain portfolio behaviour vs relevant benchmark



Calculation of loss

Loss = Performance of Actual portfolio vs Performance of ‘Appropriate’ portfolio

- Alternative portfolio is usually an index
  (key is to determining the ‘appropriate’ asset mix)
- Analysis must allow for fees
- Analysis must allow for exact timing of capital inflows and outflows

Initiatives

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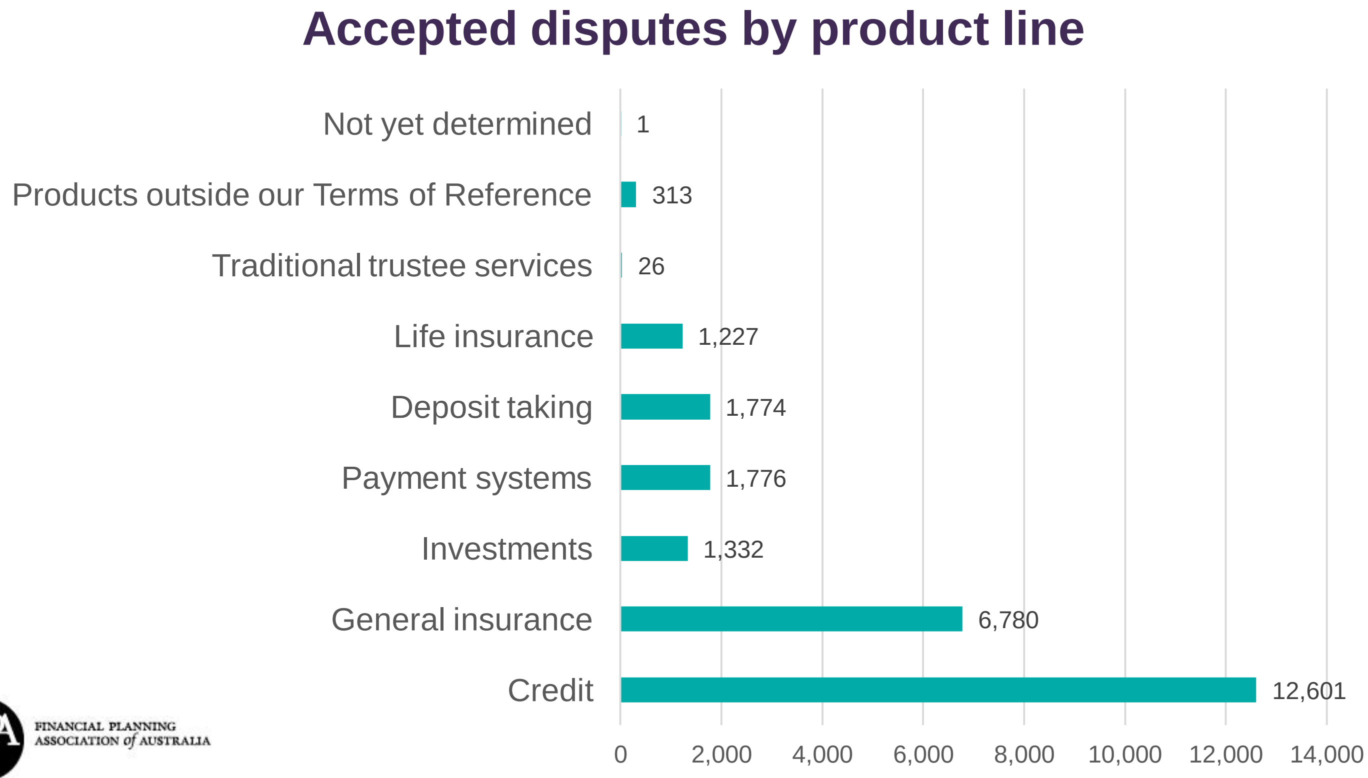
SERVICE

FOS Australia – Snapshot of 2014 – 2015

- FOS Australia received 31,970 disputes in 2014 - 2015



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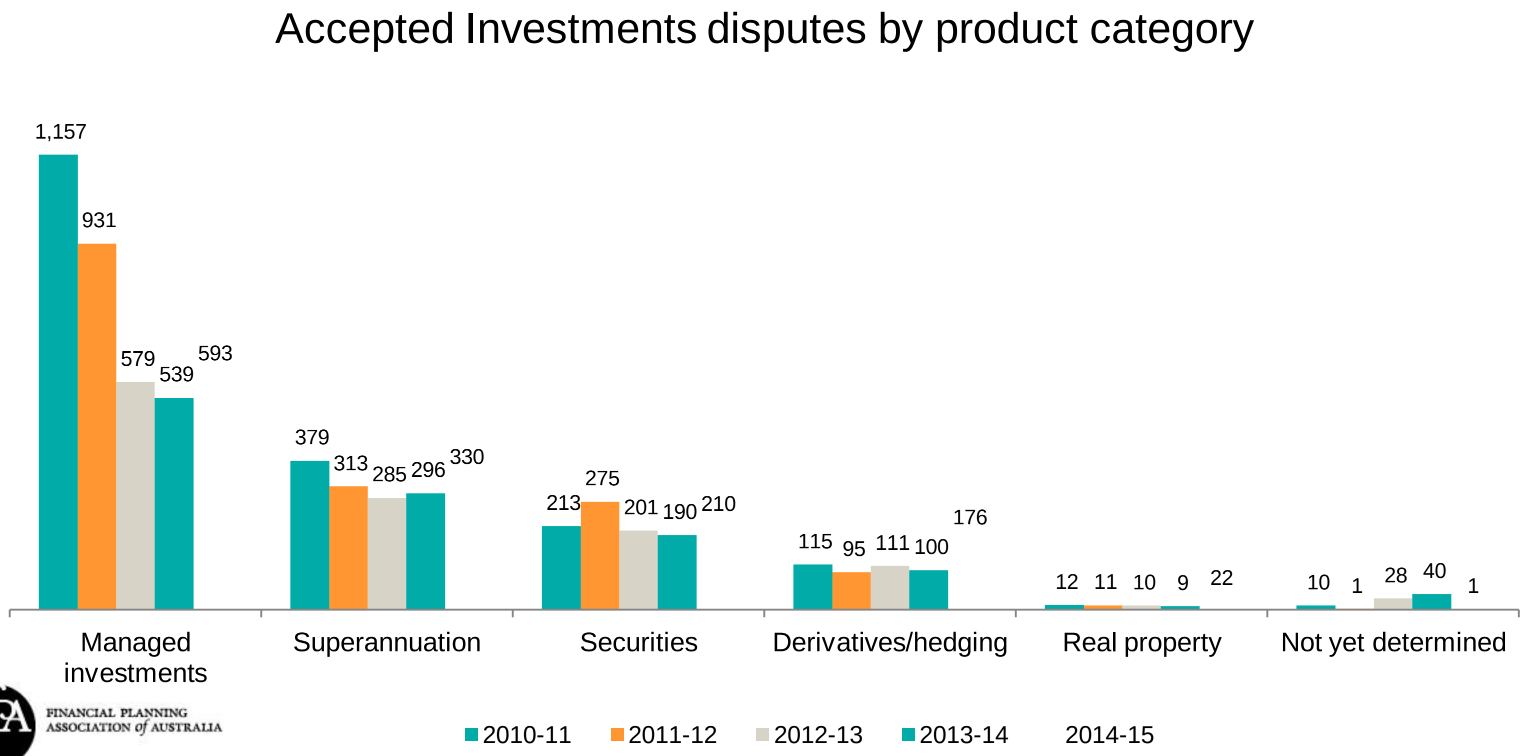
Issues with advice - Investments

- Increased 13% mainly due to Managed investments and Superannuation



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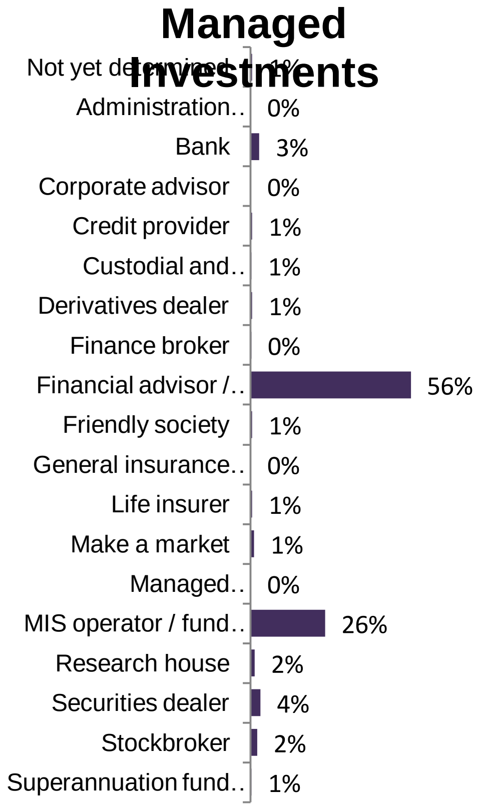
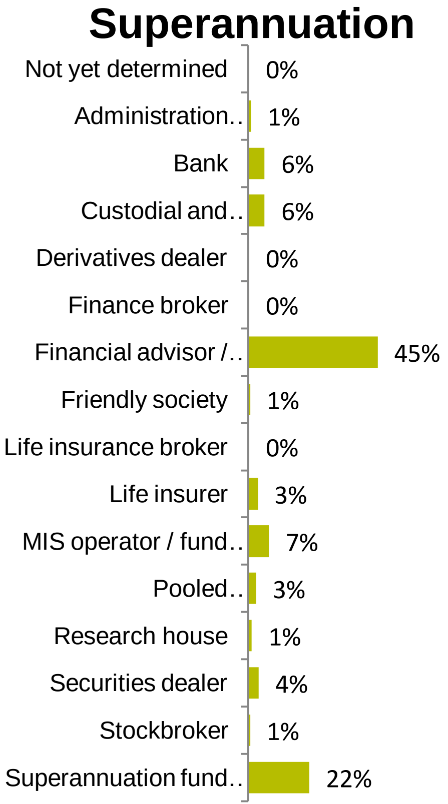
Managed Investments and Superannuation – Service Channel





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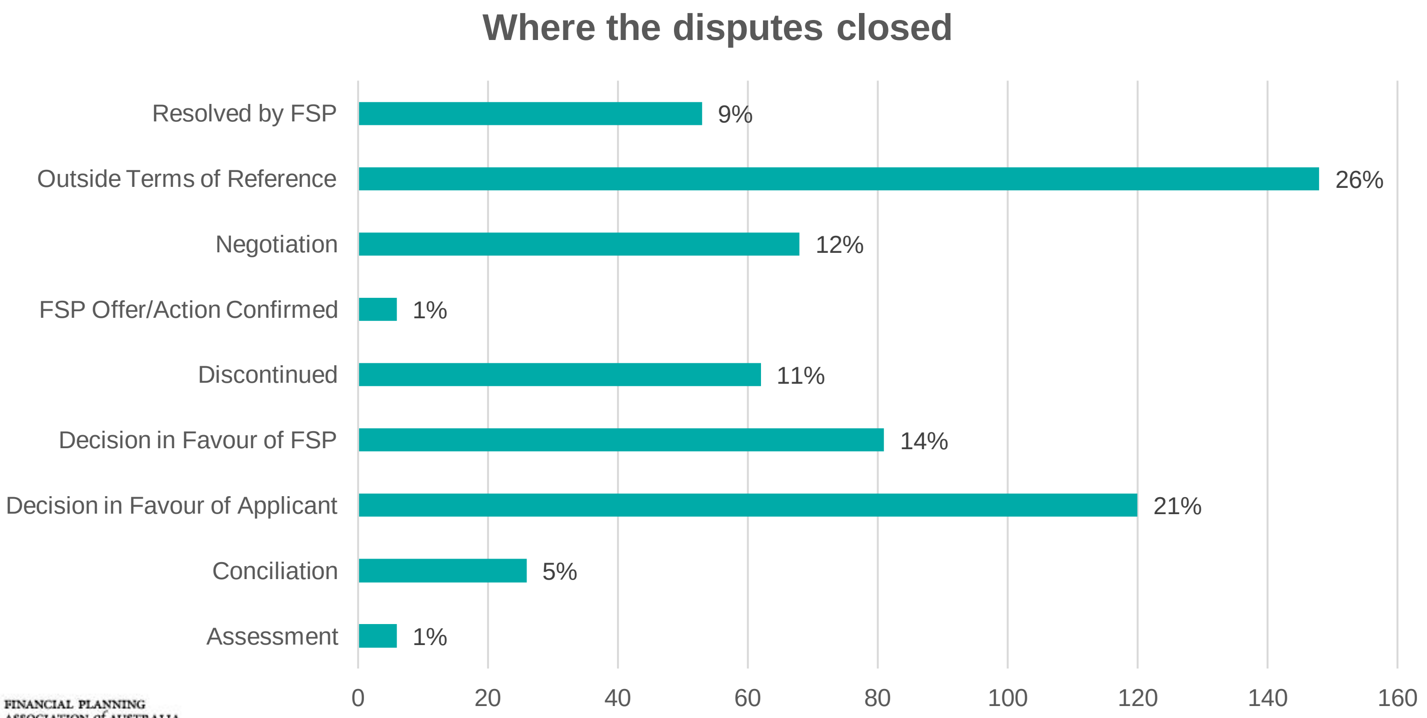
Closed Investments disputes

- Total number of closed investment disputes with advice issue: 570



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Top 10 tips for financial advisers

1. Document, document – including detailed file notes
2. Know your self – Scope the engagement and be clear on just who is the client
3. Turn clients away or refer where appropriate
4. Explain what service you can and will provide
5. Know the client – understand and be clear about goals and strategy – you must have a conversation with your client about their goals
6. Explain risk in language your client understands
7. Use template forms and documents carefully
8. Avoid cookie cutter advice
9. Use risk profiling tools and analysis carefully – it is just one aspect of the information to take into account
10. Understand and explain the financial products you recommend

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An ethical perspective

Exercise professional judgment:

1. Client first
2. Keep promises – do what you say you will
3. Act with integrity – mistakes will happen, identify, fix, remediate, learn
4. Act diligently – timely, responsive, communicate
5. Act within your competence – know yourself, your business and your service delivery and say no
6. Act objectively - don’t be tempted by “win/win”
7. Be fair – in service delivery and dispute handling
8. Professionalism – dignity and respectful dealings, cooperation,
9. Vocations serve the public interest, the profession and their client.

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