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2013 - the good, the bad and the ugly

David Maida | financialalert | 17 December 2013

No one event stood out for the financial advisory industry in 2013. Those financialalert spoke to nominated a variety of issues for our annual "the good, the bad and the ugly" roundup - and for what advisers should be doing over the break to prepare for 2014.

THE GOOD

David Greenslade, managing director of financial advisory services firm, Strategi, said a highlight of 2013 is the proposed revisions to the Code of Professional Conduct for Authorised Financial Advisers.

"On first glance, not much might appear to have changed. But a more detailed reflection over the holiday period will reveal that the Code Committee has considered the issues and carefully improved the clarity of the various Code standards, plus raised the bar," Greenslade told financialalert.

He believes changes to the Code place greater responsibility on AFAs but should elevate the level of professionalism and provide clarity around what is expected under some of the principles. Previously, the principle-based approach left some issues a bit murky for advisers.

"Advisers need to reflect on the Code, seek some advice, then re-look at their systems, procedures and documentation to ensure it meets not only the letter of the Code but also the spirit of the Code."

David Yates, general manager of New Zealand Financial Advisers' Association (NZFAA), is interested in further proposed changes to the Code, believing there is still some room for further clarification. "Most of the proposed changes are tweaks and clarifications to the current Code. But the provisions around CPD are quite significant in a positive way, as they help to provide some clarity around what is expected," he told financialalert.

Tim Farrelly, principal of investment strategy firm, farrelly's, points to the markets as one of the highlights of 2013.

Greenslade agrees. "Despite all the market noise (around tapering, sovereign debt defaults, rising interest rates etc.), investment returns from growth investments and well managed multi-sector funds with a growth bias have been some of the best I have seen in over 25

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years," he said adding that advisers who became compliant early, continued to position and market their business when times were tough, are now reaping the rewards. "They should have had one of their best years ever in terms of client investment returns, client satisfaction and business profitability."

However, Farrelly warns that markets may become overpriced in the next year or so – for example, New Zealand equities are not far away from being overvalued, particularly if there is a rise in interest rates.

With the low interest rate environment, markets can continue to rise for a long time but not forever, he said. "Over the next year, I would be making sure in my business I have got clear ways to measure when assets are expensive and what my sell triggers are. It is a time for people to be taking stock, developing a clear idea of when they want to start heading to the exits and what they might put their money into from that point onwards."

It's a matter of coming up with a plan and saying 'if this then that', he said. "Right now, given the way the markets are, having a framework is the most important thing advisers can do from an investment perspective."

Andrew Bascand, managing director and portfolio manager with Harbour Asset Management, agrees that we are not in extreme bubble territory yet, but things are clearly over-valued. If interest rates stay on hold for longer, he said, things might become even more over-valued.

Despite the world having a lot to worry about in 2013, low interest rates and quantitative easing came to the rescue, he said. "The resolve of central banks to target unemployment appears to have been a lot stronger than expectations at the beginning of the year," Bascand told financialalert. The European Central Bank, US Federal Reserve, Bank of Japan and Bank of England all followed policies in 2013 which maintained global liquidity. In China, rather than having a perceived slowdown, The People's Bank of China added to liquidity to prevent negative growth.

"We've had this continued easing bias through 2013 which is pushing forward liquidity into markets," Bascand said. "I guess the big surprise therefore has been economic growth. Growth has been stronger than we would have expected."

This year is finishing with 2.7% growth for the global economy, comprised of modest economic growth in some countries and the end of recession in others. It's down from the 3.5% long-term average but not bad.

"The key positive elements in New Zealand for this year have been the continued high level of our terms of trade with the milk price beating all expectations throughout the year. That's largely a reflection of what's going on with growth in Asia." Particularly with the Fonterra contamination scare, Bascand said its interesting milk prices are so strong. He said it is also interesting that the Reserve Bank has not put interest rates up – yet.

Bascand said he would have thought the 25% increase in domestic equities was unlikely. "About two years in a row, a 25% per annum rise in our market has therefore taken valuations of New Zealand equities to an above-average historic level."

The other highlight for 2013, Bascand said, has been the level of IPO activity. "If you had told me at the beginning of the year, the government was going to give away $4 billion worth of asset sales, I would have said that's not very likely. But they have."

Bascand was also surprised that the equities the government has sold haven't been the best performers - but the technology sector did quite well. "The final phenomenon this year has been the willingness of the market to buy forward future sales and earnings in the technology sector. We have a host of New Zealand companies in the technology sector and the market appears prepared to look forward up to five years of sales to potentially see earnings growth."

Stephen O'Connor, principal of Mitre Wealth Management, was another who pointed to the markets as a standout for 2013, and said it has helped to rebuild investor confidence. "Clients have commented on the fact that the markets have continued to perform well and asked if it will continue. That's the big unknown moving forward," O'Conner told financialalert.

O'Connor also said he is pleased that the Financial Markets Authority has continued with a principles-based approach in regards the Code. "What I have taken out from the proposed changes to the Code in recent times is that they have now recognised that not all situations require the full advice process," O'Conner said, nothing that will reduce unnecessary paperwork - and that is good for advisers as well as clients.

"One of the criticisms of the initial regulation was that it didn't matter what the client's circumstances were or what little bit of advice they were requiring, you still had to go through what was an onerous process and produce a large document that may have been of no benefit to the client."

Tony Vidler, director of fincancial adviser business service provider, Strictly Business, was another who nominated the domestic share market as the main event of 2013, partly due to asset sales and new floats. "Suddenly, domestic equities are back in people's minds as a viable option for the first time in a few years. You've got consumers talking about it. You've got advisers considering going back into that space. I think it's a big shift," Vidler told financialalert.

Vidler believes that Sean Hughes resigning as head of the FMA was also significant. "I think Sean's resignation is one of the key events regarding investment advice and regulation for the year. It's not so much Sean leaving, it's who is coming in." Hughes ends his minimum three-year contract today and FMA head of legal, Liam Mason, will be filling in until Rob

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Everett takes over as CEO on 3 February 2014.

"You would expect that ordinarily when there is a new CEO, that there will be a shift in emphasis, style and focus. The time of this resignation and the new appointment is probably, from the FMA's perspective, a good time to start doing some things a little bit differently to how they have been doing them in the last three years."

As a result, Vidler said, advisers should be aware that regulations are likely to change over the next year or two.

Mike Staal, director of New Zealand Financial Planning in Takapuna, also pointed to the performance of the markets as the real highlight of 2013. "I've been hearing, for the first time in a long time, people are almost in a bit of euphoria about the New Zealand share market which over the last five years has performed pretty well," Staal told financialalert.

He said it was 1987 when he last heard people talking about the market as if it were a given that you would get a high return. "Of course, that turned to tears big-time. I'm not saying that we're at that same level of euphoria now but what I have detected over the last six months is people have a higher level of conviction about investing in New Zealand shares but also a higher expectation."

He said the trend is a little bit of a worry. "When people start talking along those lines, history shows that things are probably a little toppy and those same people could be disappointed next year."

Overall, 2013 has also been good for adviser businesses, Staal said. "We've had a reasonable inflow of new clients and a fairly low attrition rate which is pretty much the norm for us. Advisers, be it individuals or smaller firms, have been quite mobile over the past 12 months looking for a new home that hopefully offers them the suite of services that will enable them to carry on business moving forward." Many advisers have been aligning themselves with larger groups to gain economies of scale and reduce some of the costs of compliance recently. The number of independent advisers continues to dwindle, he said.

Greg Moyle, director of New Zealand Financial Planning in Auckland, said what stood out in 2013 to him was the growth of KiwiSaver.

"When you think about it, KiwiSaver, for a young adviser starting off now is probably the future of the industry," Moyle told financialalert. He believes it will change the way financial advice in respect to retirement advice is delivered. "It's such a cost-effective way for people to accumulate and invest their money. But, given that the trail from KiwiSaver is very small, advisers will need a large client base to make a living unless they charge an hourly rate or fee. I think it will change the methodology by which advisers run their business over time."

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David Ireland, chair of the Code Committee, sees the proposed changes to the Code as incremental and not necessarily the event of 2013. Rather, he pointed to the FMA's action through the courts as one of this year's stand out features, raising the bar with regard to the directors and issuers of financial products.

The way the courts view the actions of directors with regard to disclosure is interesting, he believes. "It's a little bit of a wake-up call for the likes of Lombard. A lot of the arguments being teased out are very helpful from a compliance/learning perspective regarding lessons to be drawn and approaches that have been emphasised through those court decisions."

THE BAD

In October, NZFAA's survey of public opinion of financial advisers revealed there is still a lot of ignorance regarding regulation of financial advisers. Conducted by market research firm, Horizon Research, the survey found that almost 80% of the 2,500 adult New Zealanders surveyed knew nothing about or very little about the regulatory changes of the past few years.

"It highlights the need for us as an industry to better communicate the advice value proposition," Yates said. "We also have a long way to go to gain the trust of consumers, who are still reeling from finance company and GFC experiences. So far, the approach by FMA in terms of its focus on the legal successes has done little to improve public confidence in the sector or regulation."

Moyle believes the trend of AFAs becoming more linked with banks or other large institutions and becoming less independent is making real financial advice harder to come by for clients. "They're being sold a product. They're not being sold a plan. For an independent adviser, they ARE the product."

He is also concerned about the lack of financial literacy amongst New Zealanders. Despite finance company failures and the likes of the David Ross saga, people still don't understand that you make money by not losing it. He has a number of clients who are living longer and also spending more than was originally planned. "We need to sit down and address that in a positive way because I think it's a good thing to live longer and spend more."

Tim Williams, partner at Chapman Tripp and co-leader of the firm's financial services regulation, funds, KiwiSaver and superannuation teams, is also concerned about the NZFAA survey results.

The survey showed that nearly 70% of respondents have not changed their opinion of financial advisers since regulation was implemented. And, of those who don't use a financial adviser, 70% saw no need for one.

"It was quite negative on the reputation of financial advisers," Williams noted. "The

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conclusions drawn were that the marketplace blames financial advisers as an industry for the losses arising from the collapse of the finance companies. Rightly or wrongly, that's tainting the image of financial advisers which obviously should be of great concern to anyone in the industry."

Williams said this is a challenge for advisers because the blame may be entirely unfair in many cases. Advisers need to keep working hard to promote their reputation through their business practices, he said, adding that one way advisers can prove their worth to investors is through KiwiSaver. "If they can work out a way where they can be relevant in the KiwiSaver space, I think that would be helpful."

He also pointed to the introduction of Discretionary Investment Management Service (DIMS) regulations are another burden for advisers. But just how the FMA intends to monitor compliance will be revealed in 2014.

Vidler agrees that developments on the DIMS front were a significant development in 2013. The big stand-out was the David Ross case, he said. On 15 November this year, Wellington District Court judge Denys Barry sentenced Ross to 10 years and 10 month for defrauding investors of $115 million.

"Clearly, it's focused regulatory attention on any custodial access advisers have. That's going to change the game for a number of advisers. That emphasis on the custodial access has actually made a lot of advisers sit back and go: 'Oh, do I even want to be in that space?'"

And, Vidler said, the length of the sentence sends a strong message. "Where advisers have a legal ability to transact on a client's behalf, I think that there's been a real game changer there that's going to continue to be an area of great scrutiny for regulators moving forward."

Vidler believes the number of AFAs handing in their authorisation and quitting the game after the Ross case is no coincidence. "I think there is a link there."

Susanna Stuart, principal at Stuart+Carlyon, also pointed to the Ross case as a key highlight of 2013. What struck her was the fact that the FMA failed to prevent Ross from defrauding more than 1,200 accounts. "The new regulatory regime did not stop the likes of the Ross Asset Management debacle."

With companies and organisations focused on mitigating their own risk, Stuart asked whether the consumer will benefit in the end. "Compliance now represents a hefty component of our business."

THE UGLY

Here, the Anti-Money Laundering and Countering Financing of Terrorism Act, (AML/CFT) was an easy winner.

Greenslade believes the AML/CFT regime was a big hurdle in 2013, especially for non-QFE (Qualified Financial Entity) advisers. The whole process around AML/CFT was disruptive to business, he said. "For many, additional paperwork is now required to on-board a new client and sorting out identity requirements for elderly clients who do not have current photographic ID is a time consuming activity. Advisers and their support staff have had to invest hours of time undertaking an AML risk assessment and documenting their AML/CFT programme," Greenslade told financialalert.

And, it's not over because when reporting entities have to undergo their compulsory AML/CFT audits in 2014, they'll also incur the costs associated with that.

Yates agrees that the AML/CFT will be an on-going concern. "This legislation has imposed additional overhead on advisers not only at a transactional level in terms of having to identify the investors, interested parties and source of funds but also to have an audit of their AML/CFT provisions every year," Yates told financialalert.

O'Connor also noted that AML/CFT was an unwanted distraction in 2013. But, he said, the passing of the Financial Markets Conduct Act should be positive for investors. "It should lead to better information being available to investors and of course advisers which can only be good for everybody."

Ireland agrees the FMCA was a big hurdle for advisers in 2013. "That is the change in 2013 that's going to shape the future in terms of what's offered, how people operate and the rigor with which the market is regulated," Ireland told financialalert. For financial advisers, that means changes to the way products are disclosed and the quality of the information provided to clients.

GETTING SET FOR 2014

Over the break, Yates suggests advisers take some time to reflect on their achievements for 2013 and goals for 2014 and write them down. He suggests advisers review their business documents - for example, updating the Adviser Business Statement (ABS) and disclosure statements.

And, he said, it's a good time to prepare your professional development plan for 2014. "Take some time to look at the proposed reporting regime for AFAs and look how to capture the data required in a streamlined way so that it doesn't require a week out of the business when it comes time to report."

Greenslade agrees that AFAs should take time over the break to update their PDP and look at specialist bridging courses to bridge the gap between the old and the new Level-5. With the increased costs of doing business, Greenslade said advisers need to focus on increasing their business profitability.

"Focus on adding value where the internet and direct sales are unable to adequately do so.

This will involve providing more holistic advice with less emphasis on product sales and more emphasis on the person and helping them achieve their well-defined goals. Move from consultative to collaborative advising so you are more in-tune with the evolving buying patterns of those who have the biggest financial influence on your business profitability."

It wasn't difficult for Vidler to make suggestions for what advisers should do to prepare for 2014 because he has been telling advisers just that via his recent Strictly Business roadshow. He said advisers really need to develop some clarity of vision and strategy.

"If I was to apply a generalisation across the market over the last few years, advisers have been heads down, bums up. They've been working inside the business and they've not stopped and stepped back and thought: 'Where is this thing going? What am I trying to create? What's the end game?'"

Regardless of their business model, the most important thing advisers need to get on top of for 2014 is having a frequent and relevant client communication strategy, Vidler argued. "It's something that typically the industry is quite poor at. It's a huge issue. There is a clear correlation between high levels of communication and high levels of engagement from customers."

Moyle agreed that advisers need to update their business plans. In his view, the nature of the financial advisory business is changing. Client expectations - what they're expecting to pay and what they're expecting to get back - are all in flux, he believes.

"You need to update your business plan to make sure that your business is sustainable because at the end of the day, the clients that you're seeing today, you're making a commitment that you'll be there tomorrow and the day after and the day after. Otherwise, they'd be better off talking to someone else."

Not surprisingly, Ireland recommends that during the summer break, advisers take another look at all of the guidance notes on the FMA's website and take stock of their business to make sure they comply. "There are a lot of consistent themes running through those in terms of the expectations and what they (FMA) are looking to see in a variety of situations. A lot of which if it's not directly on the point of what you're doing is still insightful as to what expectations might be from FMA."

He agrees that the FMA's expectations are placing more pressure on adviser's time - but they can do something about it. "You save yourself a lot of time down the track by getting your systems, paperwork and everything as good as it can be and fully informed by the guidance that has been issued."

He also suggests advisers pay more than just lip service to developing their professional development plan. "It is actually about assessing what you know. Where are the gaps? How am I going to maximise my time or maximise the value I get from my CPD? It's going to be increasingly important," he said.

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Looking to 2014, Williams has an eye on interest rates. "As they start going up, obviously the investment world is going to change a little bit. Advisers will obviously have to be wary of those changing times and the prospect of inflation."

Bascand is on a similar wave length. Over the break, he suggests advisers read Lawrence Summers' "Deflation and Secular Stagnation – The Real Threats to EM". He also recommends keeping up with PIMCO and the Bond Vigilantes. "If you really want to go to sleep, read the latest Reserve Bank Financial Stability Report.

Plus, he recommends advisers read any news articles regarding Beijing's significant reforms. "I think it's important in this part of the world that we understand what's actually going on in China and the influence of greater consumption and what that might mean." Harbour Asset Management recently released its views on China's reforms.

Staal agrees that over the break, advisers should continue to keep their ears to the ground and do their reading in order to maintain best practice. "We review ourselves. I would argue sometimes we're perhaps our own harshest critics in order to make sure were doing, hand on heart, the very best for our clients."

Stuart said the summer break will be a welcomed time out. "We've had a huge workload this year with a significant increase in new business so we are looking to recharge our batteries over the holiday period. Each year, and it's no different for 2014, we are looking to make our business more efficient to cope with the onslaught of processes necessary to comply with the never ending regulations. As always, our foremost focus is on our clients and how we can better their lives."

We'll leave the last word to O'Conner. He believes the most important thing advisers should be doing over the holiday season is just recharging their batteries. "The first thing that advisers should be doing over the summer holidays is spending time with family and friends and enjoying the gifts of life. They shouldn't be worrying about business."