# Senate Select Committee on Superannuation and Financial Services

# Main Inquiry
# Reference (a)

**Submission No.** 55 (Supplementary to Submissions Nos. 37 and 46)

Note: Also Submission No. 19 to Reference (b)

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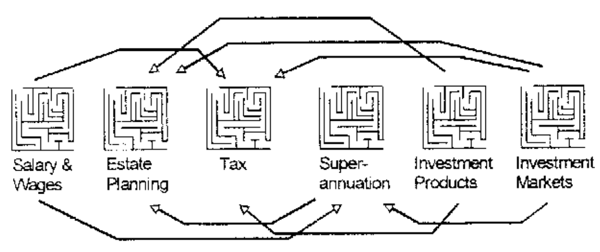


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RECEIVED 6 JUL 2000 Senate Superannuation & Financial Services Committee

30 June, 2000

Ms Sue Morton FAX: (02) 6277 3130 PH: (02) 6277 3433
Secretariat, Senate Select Committee on Superannuation & Financial Services
Parliament House
Canberra ACT 2600

Re: Further comment on questions asked by Senators at the Brisbane public meeting.

Dear Sue

As you know, I was asked to attend the Brisbane committee meeting on 16th June. I have been giving further thought to some of the questions that Senators asked me on that day. These issues include the following:-

- Senator Lightfoot asked what would I do with **an investor who wanted high returns but no risk.** This is a very important question, which financial planners are often faced with. I enclose a copy of the FPA's Practice Guideline for Risk Disclosure. This might help the Senators understand how as financial planners we need to deal with this, and why. If you refer to Section 2.11 on page 5, you will note **our obligation to "provide an explanation of the nature of the investment risks involved in terms that the client is likely to understand."**

  **Explaning the nature of the investment risks involved in terms that the client is likely to understand** is a non-trivial task. It involves making a proper assessment of the client. It also involves the process of explaining. But most importantly, it involves the education of the client. And as I mentioned in answers to questions on the 16th June, it is my experience that the education process (to get a client to a level of knowledge that I might be happy with) to best help a client achieve their objectives, takes about 2-3 years. {Just to complicate things, as we have seen over the last few years, the experts don't always agree on the "nature of the investment risks", as experts have argued over whether we were seeing a classic speculative bubble in stock markets or whether there was a sustainable basis for some very high Price/Earnings ratios.)

  It is therefore very clear that Senator Lightfoot was putting his finger on a very key issue. Because a financial planner must **"provide an explanation of the nature of the investment risks involved in terms that the client is likely to understand", the financial planner cannot provide the best possible advice** ***until the investor is prepared to learn and understand about investment risks.*** Sometimes it takes new clients and regulators a while to appreciate this point. And because this task is usually non-trivial, necessarily the costs are non-trivial.

- **A number of questions (from Senators) suggested to me that the role of a financial planner was not clear.** While it is true that there is a wide range of different types of services from different financial planners (as there is a wide range of different types of services from accountants), there are



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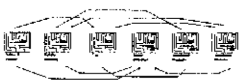

some common themes in the role of the financial planner. I enclose a few pages from the "Users Guide" that I give new clients (not for publication ... just to assist the understanding of the committee). This should give you a greater sense of the tasks involved ... and why financial planning is such a time-intensive task.

**I also sense that Senator Sherry is sensitive about the magnitude of costs of a financial planner.** Perhaps the Users Guide, by helping to clarify the amount of time required, will also help Senator Sherry appreciate why costs are what they are. One of the challenges before the Committee (and perhaps before the financial planning community) is how some subset of quality financial planning services can be made more available to the public. From an advisor's perspective, **one of the biggest obstacles to providing a lower cost subset of services, is financial risk to the advisor.**

Perhaps Senator Sherry's concern about costs relates to over-charging by some advisors, failure to disclose fees or some other unethical behaviour. Unfortunately, as with all professions, there is always going to be some who do not behave as ethically as the community would like. The Financial Planning Association (FPA) is also very concerned to eliminate unethical behaviour and I think you will find that it is increasingly difficult for an advisor to retain membership of the FPA, if there is evidence of unethical behaviour. However, clearly the FPA cannot impose sanctions on advisors who are not members of the FPA.

- **Lyn Allison asked whether there was "any other relevance" of the mining industry's seemingly poor performance.** My understanding is that the Committee is interested in *Australia becoming a financial centre for Asia*. Why would we want Australia to become a financial centre for Asia? Surely the only reason could be, "that by doing so, we could improve the standard of living for Australians". So one of the points I was making was related to the broader question, of "what obstacles there were to Australians having a higher standard of living". My view was that I felt that, in its current form, the mining industry may be more of an obstacle to a higher standard of living, than a help. From the graphs that I provided the committee, superficially it would seem (from a Boston Consulting Group style of classification) that the mining industry in its current form, is a "dog". The Boston Consulting Group (BCG) would go on to suggest that with a "**dog**", you should be looking to either 1) turn it into a **"cash cow"** [eg by requiring higher royalties], or 2) **get rid of it**, or take some other action to help it make a positive contribution. It seems unlikely that you could revert the mining industry back into a **"star"** (the remaining BCG classification) as it clearly was early in the twentieth century.

  Please also note that the enclosed AFR news article which raises some related issues.

- Further, on the question of **Australia becoming a major financial centre for Asia**, in my 14th June submission extension, I suggested that this was a pipe dream. Yes, I do think that there are short-term opportunities for Australia to sell more our expertise for financial services into Asia, but over the medium-term I think that it is already virtually certain that the major financial centre for Asia (outside of Japan) will be Asian. I think we are already in the end-game of these developments and probably too late for Australia to have a major bearing on the outcome. (This is not to say that Sydney cannot play some more minor role as a financial centre in the region ... or play a role in co-operation with the world's major financial centres). The only question is, what form it will take. So let us consider what form it might take, because that will help us to understand how Australia can play a more complementary role.



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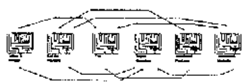

Tokyo is already a major financial centre in Asia of course. Where else might a major financial centre spring from? I would ask you to think 10 or 20 years down the track, and think of the possibilities. Let us consider the economies of Singapore, Taiwan and Hong Kong, and let us compare this to Australia.

| | Population | GDP in US$ | Per Capita GDP in US$ |
|---|---|---|---|
| Australia | 19million (2000) | US$367b (1996) | US$20 090 (1996) |
| Singapore | 3.2million (1998) | US$93b (1996) | US$30 550 (1996) ie.1.5 x Aust |
| Hong Kong | 6.6million (1998) | US$153b (1996) | US$24 290 (1996) ie. 1.25 x Aust |
| Taiwan | 21.8million | US$297b (1998) | US$13 900 (1998) |
| S+H+T | 31million | ***US$543b*** | |

Source: Encyclopaedia Britannica

Why are these statistics of relevance?

- What if, over the next 10 years or so, **Singapore, Taiwan and Hong Kong** created a merged financial centre? **Please note that in combination, these 3 economies already have a 50% larger economy than Australia** and a 50% larger population. Keep in mind that a few weeks ago in Sydney, the deputy prime minister of Singapore expressed a view that it was "inevitable" that Taiwan would be merged back into China. With the globalisation of the world (for companies and countries), opportunities like the merging of the above three will probably become political imperatives. However, other patterns may well develop and perhaps we might influence the final patterns if we put our minds to it. Lets make sure we focus our efforts where we can have the biggest influence in improving the standards of living for Australians.

- I also wanted to use these statistics to further highlight how far we have already fallen behind the per capita GDP of some of the countries to our north. Needless to say, Japan's per capital GDP is already twice ours. As a country, we must focus on this problem or we truly will become the poor nation in Asia. While this is not the focus for your committee, **I think your committee (together with others) has to consider this issue**. Your committee can help Australia find solutions to this problem. Otherwise, why even bother considering the question of "making Australia a larger financial centre?

Yours Sincerely

Bruce Baker

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Certified Financial Planner
Director & Authorised Representative, Puzzle Financial Advice Pty Ltd

Enclosures:

FPA Risk Disclosure Guideline. — NOT PUBLISHED.
Excerpts from my "Users Guide" to give you a greater sense of the process of financial planning.
AFR article "How the West lost its sway in the East" dated 21/6/00.
AFR article "Resource sector under siege" dated 29/6/00.
Corrected Hansard of the Committee meeting of 16th June 2000. – not included in submission.


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AFR 29/6/00

Mining's earnings outlook, **MW3.**

**Investment:** The rise and rise of indexed funds in Australia, **MW2.**

**Bonds:** Brisbane Airport Corp's $350 million bond issue takes off, **MW4.**

**20-PAGE LIFTOUT**

**Sweet and fizzy**
Brewing giant San Miguel may buy back Coca-Cola Amatil's Philippines bottling business, **page 13.**

**Up for grabs**
Buying surge expected in residential property markets as new first home owners scheme begins, **page 28.**

**Pump priming**
Canberra's petrol price row escalates, **page 4.**

**Digging in**
Fiji's armed forces set to rule for two years, **page 10.**

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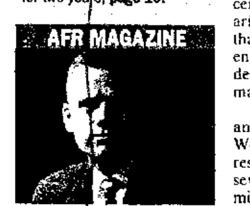

**Four men & a wardrobe**
Who says blokes can't dress? These role models strut their stuff.
**By Mellsande Clarke**

**FREE THIS FRIDAY**


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# Resources sector under siege

**Ian Howarth and Bruce Hextall**

North Ltd yesterday mounted an aggressive defence against Rio Tinto's $2.8 billion takeover bid, labelling it "a very cheap opening shot" that was "trying to cheat the shareholders".

But North's managing director, Mr Malcolm Broomhead, is not the only resources chief executive who is feeling vulnerable.

Rio's hostile bid has highlighted the plight of Australia's resources companies. Once the backbone of the sharemarket, they are now the prey of offshore predators.

Although the resources sector is forecast to produce a record $46 billion in exports in 2000-01, the weak Australian dollar, poor earnings performances and open share registers have made MIM, Pasminco, WMC and Anaconda Nickel prime targets.

Only 10 years ago, the resources and oil sector made up about 40 per cent of the stockmarket's All Ordinaries Index. Today, it accounts for less than 16 per cent following the emergence of telecommunications and demutualised insurance and funds management groups.

In the wake of Rio's bid for North and Shell's grab for control of Woodside Petroleum, international resource groups are now evaluating several balance sheets in Australia's mining and oil sector.

Yesterday, Mr Broomhead also took the unusual step of quitting his executive duties to head a team of executives and advisers that will try to extract a higher bid for Australia's third-largest iron ore producer.

The move came as Rio revealed the takeover would deliver up to $400 million in savings from merged iron ore operations in the Pilbara region of Western Australia.

Rio's takeover play is seen by analysts as the start of a shake-out that will involve international groups bidding for local companies and rationalisation among the domestic players, with BHP and the Normandy Mining

**Continued page 17**

**Nowhere to hide . . . resources companies are increasingly becoming the targets of unwelcome interest from overseas.** Photo: VIRGINIA STAR

# C&W dials Optus mobile buyers

**Christine Lacy**

Telecom New Zealand is investigating the purchase of Cable & Wireless Optus's $15 billion mobile phone business following an approach by Optus's United Kingdom-based parent.

It is believed Cable & Wireless plc has also sounded out other international players about a possible sale of Optus's very profitable business, which holds 33 per cent of the local mobile market.

Telecom NZ is understood to be ... second-ranked Australian mobile player as part of a strategy to create a pan-Asian mobile venture similar to the operation being put together by Telstra Corp and Mr Richard Li's Pacific Century CyberWorks.

News of the negotiations has raised fresh speculation about a break-up of Cable & Wireless Optus, which would in effect see Optus disappear from the consumer telecommunications market in Australia.

The break-up has been constantly denied by the management of the Australian subsidiary, which gener... its mobile business. But it is believed the approach to Telecom NZ came directly from the UK, with local management not involved in the talks.

Optus's chief executive, Mr Chris Anderson, is on leave, but a company spokesman said yesterday any suggestion that the mobiles business was being sold was "untrue".

"The story that our mobiles business is being sold is completely untrue," he said, denying that any potential buyers had been sounded out.

Optus's managing director of the mobiles business, Mr Paul O'Sullivan,

# Resources sector under siege

From page 1

group well positioned to expand.

While Normandy is one of the world's largest gold producers, it could also be a target for the likes of South Africa's AngloGold and Barrack Gold of the US because of its premium suite of Australian assets.

BHP has concentrated on a massive restructuring under chief executive Mr Paul Anderson, who has put the company in position to become a major global minerals player through acquisitions and alliances.

The drop in importance has not been restricted to Australia, with the total market capitalisation of global resource companies at about $US400 billion ($670 billion), or about 2 per cent of the capitalised value of the world stocks.

A globalisation in the sector, highlighted by mergers in the oil industry and Rio Tinto's takeover of CRA and mop up of Comalco, has also contributed to the massive reduction in its weighting in the equities market.

The demise of local ownership has raised concerns about "selling off the farm", although the Federal Government is unlikely to slow the process through its foreign investment laws.

"We certainly haven't picked up any barrage from the Government on rationalisation in the sector being detrimental to Australia," said Australian Gold Council executive director Mr Greg Barns.

He said that if regulatory hurdles, including Foreign Investment Review Board requirements, were overcome, the Government was supportive.

"It is a two-way street. It is an industry which is becoming increasingly borderless," Mr Barns said.

The need to get bigger to compete globally is expected to trigger the rationalisation in Australia.

There were "a variety of reasons for the accelerating pace of takeovers", Rothschild Australia Asset Management's resources portfolio manager, Mr Stuart Dodd, said.

The low value of the Australian dollar had helped. But, Mr Dodd said the cheapness of Australian resource stocks relative to international companies was a bigger factor.

"It is a question of value, and right now the managers of resources companies are recognising it is more rational to grow their businesses through mergers and acquisitions," he said.

The largest of the mooted takeover targets is WMC, which could become a break-up play.

Its alumina joint venture partner, the financially strong Alcoa Inc, could take the opportunity to gain control.

Analysts are divided about whether WMC is a target or an acquirer. It is tipped as a likely buyer of North's uranium offshoot, Energy Resources of Australia, should Rio succeed with its bid for North.

Companies with corporates as a strong presence on their share registers are also obvious targets.

These include Goldfields, which now has South Africa's Harmony Gold as a 19.9 per cent shareholder; minerals sands producer Ticor, already controlled by South Africa's Iscor; and coal group QCT Resources. QCT could be in play after oil and gas producer Santos Ltd decided its 34 per cent stake in the Brisbane-based company was no longer a core investment.

In the oil and gas sector, Oil Search could be vulnerable once development approval of the PNG-to-Queensland gas pipeline was gained. Woodside has approximately 15 per cent of the company.

Laterite nickel miners Anaconda Nickel and Preston Metals also possess valuable assets.

Anaconda's price soared to its highest level in three years this week after major shareholder Anglo American revealed it had increased its stake to 24.16 per cent from 23 per cent.

According to some analysts, many of the best operators have already fallen victim to takeovers or mergers.

**"The demise of local ownership has raised concerns about selling off the farm."**

"We are running out of suspects," BT Funds Management's head of equities, Mr Steve Giubin, said. "The bane of the [resources] industry has been very poor returns on capital employed."

The drive for global resource-sector mergers was driven by the need to improve capital returns.

This was being achieved by company mergers to produce growth rather than building new mines that added to global production, forcing commodity prices lower and damaging company profits.

"The listed [resources] sector will shrink and it has only itself to blame because of its poor return on capital over a long period," Mr Giubin said.

Also Govt policy.

Among the prey in the past year have been QNI Ltd, Comalco Ltd, Ross Mining, Acacia Ltd and Great Central Mines, who have all disappeared from the stock exchange.

Nevertheless, companies such as AngloGold and US-based Homestake Mining are showing an unabated appetite for Australian assets.

Yesterday in Paris, AngloGold executive director Mr Kevin Williams reiterated his company's interest in local stocks even after recently acquiring Acacia Resources. He said AngloGold would buy more Australian assets but was interested only in companies that produced gold at under $US200 an ounce.

Aurora Gold and Delta Gold (before its recent Solomon Islands problems) each fell in that category.

Recently the bulk of Australia's coal industry has been sold in a dramatic consolidation of ownership, and the world's aluminium industry has contracted to five main players.

Rio Tinto's move to 100 per cent ownership of Comalco was followed by Capral Ltd's sale of its Kurri Kurri aluminium smelter to Germany's VAW group. In Victoria, Alcoa took over Eastern Aluminium to consolidate its position as major owner of the Portland Smelter.

Explosive issue? North has labelled Rio Tinto's takeover bid 'a very cheap opening shot'. Photo: VIRGINIA STAR

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# How the West lost its sway in the East

**Peter Hartcher** reports on a new anti-westernism among East Asia's elite.

The panellists at the conference on Asia were supposed to be discussing something else, but there was a big, submerged issue which could not be suppressed.

It was the South Korean speaker who first broached the idea: that the East Asian nations build a $US100 billion ($170 billion) fund to protect themselves against crisis because they could no longer trust the West.

And one after another, speakers at a major regional conference this month endorsed the concept of an Asian Monetary Fund – the Indonesian central banker, the Singaporean finance official, the former Filipino Cabinet minister.

These are no ignorant neo-rightist bigots but men educated in the best academies of the West – Harvard and Oxford and the London School of Economics – bicultural, fluent in English and leaders in their national elites.

"There is much more support for this idea than I expected," said Mr Yung-Chul Park, chairman of a key State-owned bank, the Korea Exchange Bank. "The crisis was really painful and humiliating and they are prepared to go all out to forestall a further crisis.

"We simply cannot wait for the Group of Seven [richest industrial countries] to reform the international system. Because it's going to be nowhere when the next crisis hits. They will not be there to rescue us."

Across East Asia there is frustration with perceived Western negligence and the high-handedness of the Washington-based International Monetary Fund.

At its core lies a new anti-Americanism. A leading intellectual and former Finance Secretary of the Philippines, Dr Jesus Estanislao, said: "When people really think what they mean by East Asia, they mean, 'US out, let's do things on our own.'"

East Asian opinion leaders also feel a new sense of shared threat.

"We have learned that one country's crisis is no longer a remote fire but your problem the next morning," said one of the Japanese advocates of the fund, Mr Hajime Shinohara, the deputy governor of the Deposit Insurance Corp, a government entity.

At the instigation of Japan's Finance Ministry, Mr Shinohara has been moving about the region proposing a fast-moving $US100 billion fund – with half the capital contributed by Japan – and a Tokyo-based secretariat of 200 to 300 staff.

The Japanese first advanced this idea in 1997 as the crisis broke. It was vetoed by the US and opposed by Australia. These governments feared it would be a Japanese-run slush fund for buying political influence, handing money unconditionally to countries in crisis.

This left the IMF as the unchallenged dispenser of emergency credit, the arbiter of economic policy across half of Asia.

As a result, *Asiaweek* magazine decided that the most powerful man in Asia in 1998 was not an Asian or even a resident of Asia, but the IMF's then managing director, Mr Michel Camdessus. Although Mr Camdessus is French, his policies were widely seen as being those of the IMF's biggest shareholder, the US Government. This smarted.

So now the idea of an Asian fund has new momentum. East Asian elites are being drawn together by a powerful sense of post-crisis regionalism. It is part reason, part emotion.

It extends well beyond the Asian Monetary Fund. There is new vigour in exploring regional arrangements in finance, trade and politics.

"At the time of the crisis in Asia, people were sceptical about regional solutions. But now there is a groundswell in favour of them," said a man who works closely with governments on these issues, the manager of the regional economic monitoring unit at the Asian Development Bank, Mr Pradumna Rana.

"Trade co-operation is already under way and now we are moving into monetary areas. It's a regional watershed.

"You have to understand how dramatic this change is. ASEAN [the Association of South-East Asian Nations] for 30 years had a principle of non-interference in each other's affairs. Now governments are submitting to peer review of their economic policies.

"It is maybe not so different to Europe in the late 1950s," he said, referring to the dawning of European integration.

Japan dominates the economy of East Asia. Its annual output is worth about $US4.5 trillion, about half that of the US. Even after a decade of stagnation, Japan's is still the world's second-biggest economy and twice the size of that of the next-ranked, Germany.

The rest of East Asia – the larger northern economies of China and South Korea, plus the clutch of 10 smaller ASEAN members – has an annual output worth $US2.1 trillion. The region's total economy of $US6.6 trillion means it accounts for about a fifth of world output.

These countries are already more closely integrated: collectively, 55 per cent of all East Asian trade is with other East Asian countries, compared to only 30 per cent in 1996.

Now they are working on agendas that would bring them much closer.

In trade, there is feasibility work under way on two major initiatives. Both are in their infancy. One is the ASEAN Plus Three proposal for a free-trade area embracing all East Asia. The other is for freer trade between Japan and South Korea.

In finance, the governments of East Asia agreed last month on the so-called Chiang Mai Initiative, a network of currency swaps between member countries to allow them greater liquidity in the event of crisis. Now there is pressure to move towards an Asian Monetary Fund.

In politics, there is a mushrooming of meetings, but the most significant may be the ASEAN Plus Three agreement to an annual heads-of-government meeting.

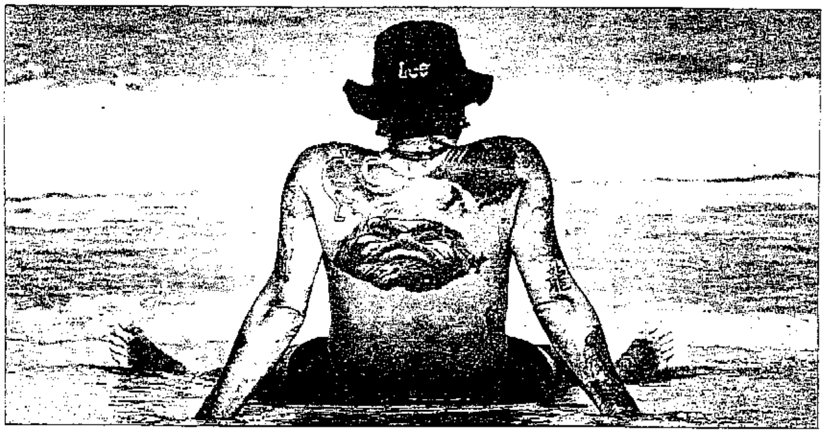
But there are as many differences between the East Asians as similarities, and obstacles aplenty to integration.

The chief strategist at Singapore consultancy Strategic Intelligence, Dr Yuwa Hedrick-Wong, said: "There might be something in it politically for the ASEAN Plus Three to get together, but from an economic point of view this so-called new regionalism is already an anachronistic idea.

"There is a global market and these countries are part of it. For example, everyone except Malaysia has given up on the idea of a national car project – the Chinese, the Thais, the Indonesians and the Koreans have all abandoned the idea."

The Korea Exchange Bank's Mr Park agrees that there are problems to surmount in advancing regional integration: "The only way to get a consensus in East Asia," he quipped, "is for me to threaten to punch all the other guys."

■ *This concludes a three-part series.*



**Australia is on the wrong wavelength in Asia: resentment against the West is just too strong at the moment.** Photo: AP

## Not only white, but beyond the pale

**Peter Hartcher**

**Why can't Australia be included in the new groupings taking shape in Asia? "Because you are white," comes the answer from a leading intellectual and former Finance Secretary in the Philippines, Dr Jesus Estanislao.**

Don't get him wrong. He supports Australia and New Zealand's inclusion. "There are a number of us who are very uncomfortable with a narrow, racially based regionalism.

"But despite all the denials, much of the energy driving the new agenda is just that. It has a strong emotional momentum," says Dr Estanislao, the Philippines representative on APEC's Eminent Persons Group.

"That's why it's a good idea to bring Australia and New Zealand in – it would defuse it, make it less racial, more open, to make sure we don't create a dividing line across the Pacific."

Dr Estanislao, Harvard educated, was Cory Aquino's Secretary of Economic Planning and later Finance Secretary. He is now, among other things, president of the Institute of Corporate Directors.

"Australia and New Zealand also have a lot to bring to the table – on corporate governance for example, where you have a different experience and therefore a good contribution to make."

But the climate of Asian neo-nationalism and resentment against the West is just too strong at the moment, he says.

He adds that Australia damaged itself in the eyes of the region by being seen to be too aggressive and jingoistic in East Timor. "That hardened sentiment against Australia."

Australia has not been invited to join the new trade, finance or political groupings taking shape in East Asia.

But the region looms particularly large for Australia – it buys exactly half of everything that Australia sells to the world. It is also, of course, the region in which Australia must find its security.

The senior deputy governor of the central bank of Indonesia, Professor Anwar Nasution, says that Australia should be included: "You bring some of the good Anglo-Saxon traditions with you, for example your approach to education.

"In East Asia we still have the mandarin model – you have to massage the leg of the guru before he will tell you anything.

"Australia is not a big market but you are rich in resources and ideas."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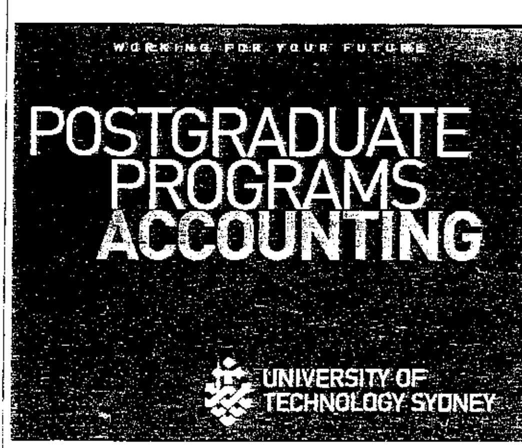



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# PRACTICE GUIDELINE NO.2

## Risk Disclosure:
Explaining the relationship between risk and reward to clients

EFFECTIVE DATE: 1 JANUARY 1999

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**Disclaimer**

The Professional Standards of the Financial Planning Association of Australia Ltd (FPA) comprise the Code of Ethics and the Rules of Professional Conduct which are enforced through the Financial Services Complaints Resolution Scheme and the FPA formal Disciplinary Procedures.

The FPA also issues Guidelines to illustrate the practical application of FPA Professional Standards and to assist Members in better servicing their clients. As such the FPA does not intend for this risk disclosure guideline to be prescriptive or mandatory.

Members must seek their own legal advice concerning their obligation to disclose risk to their clients. Members should not rely on this guideline for explanation of their legal duty.

The FPA disclaims any liability for any detriment suffered by anyone who acts on anything contained in this Guideline.

## 1. Risk in Perspective

1.1 Risk taking lies at the heart of our financial system. Investors need to understand the risks they are taking so they can properly assess the returns expected from their investments. The financial planner's role is not to avoid risk altogether (which is impossible) but to assist clients to learn to embrace and manage reasonable investment risks to achieve their desired investment goals over realistic time frames.

1.2 Certainly the inherent uncertainty facing all economic activity has been amplified by the globalisation of markets and the volatility of business cycles.

1.3 The fear of losing money can be a significant motivator for many investors. However, risk disclosure is not primarily about issuing worst case scenario disaster warnings to simply alarm potential investors and thereby scare them off a sensible long term investment plan. It is about assisting clients to better appreciate the risk/reward relationship as it relates to the material investment risks and associated rewards faced by clients when choosing to accept a financial planner's recommendations.

## 2. Background

2.1 The Australian Securities Commission's Good Advice Report included a proposal that the ASC would "...strongly encourage all securities advisers to adopt as best practice the provision to retail investors of information on the risks associated with recommended investments and any investment strategies." (Good Advice Report, November 1995 at page 33).

2.2 The ASC acknowledged that risk disclosure was not currently an express requirement in the Corporations Law.

2.3 However, in the light of the common law obligations of a securities adviser, the ASC considered the duty to disclose investment risks as being implicit in the general obligation of licensees to conduct business efficiently, honestly and fairly. The ASC also encouraged industry and investor representatives to develop an accepted best practice for risk disclosure (Good Advice Report page 11).

2.4 In 1997 the ASC's Good Advice Policy Statement 122 Investment Advisory Services: the Conduct of Business Rules (at paragraph 100): stressed the importance of advisers (as a matter of best practice) telling their client about "any significant risks" associated with the investment and any investment strategies recommended to a client.

2.5 The Government's response to the Financial System Inquiry Report's recommendations (as contained in the Corporate Law Economic Reform Program or "CLERP" Paper No.6) proposed that all financial intermediaries provide a risk disclosure statement to clients which includes generic and specific risks of investment products (CLERP Paper No.6 page 100).

2.6 The Australian Securities and Investments Commission (ASIC) has a clear objective to "promote the confident and informed participation of investors and consumers in the financial system". Whilst regulation is

not designed to guarantee the success of an investment opportunity, investors should be given sufficient information to make informed decisions about financial products and services. Clear understandable disclosure of material investment risks would fall into this objective.

2.7 Common Law Duty of Care
Case law suggests that where a professional adviser provides advice to a client, **the professional is obliged to warn the client of any material risks inherent in the client taking that advice** ***(see Rogers v Whittaker 1992 175 CLR 479)***

2.8 The High Court in that case (a medical negligence case) considered a risk to be *material* if:

- A reasonable person, if warned of the risk, would be likely to attach significance to it; or
- If an adviser knows that a particular person would be likely to attach significance to it (ie. whether reasonably so or not); or
- If the person asks questions revealing concern about the risk.

2.9 The foreign currency loan bank cases emphasise the heavy reliance and trust placed on advisers particularly by financially unsophisticated clients. A number of judgements found a duty of care on bank advisers to identify and explain the risk faced by customers borrowing offshore.

2.10 In the context of this background, FPA developed a new Rule of Professional Conduct (Rule 111) which became effective from 1 May 1997 following the adoption of a completely revised set of Professional Standards by the FPA.

**2.11 RULE 111 states that:**

**"In preparing oral or written recommendations to clients a Member shall provide an explanation of the nature of the**

**investment risks involved in terms that the client is likely to understand."**

This guideline seeks to assist members in their application of Rule 111.

## Scope of Guideline

3.1 This Guideline is applicable to all FPA Principal members and their proper authority holders providing financial planning services.

3.2 This Guideline deals with disclosure of investment risks and investment strategies and does not cover other kinds of unexpected events such as serious illness, death or loss of employment which can also have a major impact on a person's financial situation. FPA Rules 105 to 112 set out minimum requirements for FPA members when preparing recommendations. A client's capacity to accept certain investment risks would normally be dealt with during the course of collecting sufficient information about an individual's circumstances under Rule 108.

3.3 The adviser's undertaking to explain significant risks of investments and strategies is also specifically covered in ASC Policy Statement 121 at paragraphs 46-48 (Advisory Services Guides). From October 1, 1998 an Advisory Services Guide must be given to all potential new clients and contain a statement along the lines: " We will explain to you any significant risks of investments and strategies which we recommend to you. If we do not do so, you should ask us to explain those risks to you"

3.4 FPA believes that section 1022 of the Corporations Law imposes an obligation on prospectus issuers to provide an adequate explanation of the investment risks inherent to the product or strategy offered via the prospectus.

3.5 Whilst advisers may make specific reference to the risk statements set out in prospectus documents, FPA does not believe that FPA members can rely solely upon such explanations within prospectuses to discharge their duty under FPA Rule 111.

## 4. Explaining investment risks

### *What investment risks should you explain?*

4.1 For the purpose of this Guideline, **"investment risks"** means those material investment risks and material investment strategy risks included in any recommendations made to a client. Strategy includes asset allocation, portfolio construction and gearing risks.

4.2 Examples of the more common risks which might be relevant to clients are listed below. The FPA has not attempted to provide an exhaustive list of every conceivable investment risk. There are other types of risks not mentioned below which may require disclosure and explanation in particular situations.

**Inflation risk** — The possibility that the purchasing power of your money may not keep pace with inflation (eg. by not investing at all or not investing sufficiently in growth products). The risk is a poor **real return** on funds invested.

**Risk of not diversifying** — The possibility that if you put all your investment capital into one basket (eg. the share market) a fall in that market will adversely affect **all** of your

capital. **Diversification** is a deliberate strategy aimed at reducing the impact that volatility in one asset class, sector or single product will have on your overall portfolio of assets.

**Market risk**

The possibility that movements in a market can cause an investment to decrease (as well as increase) in value.

**Re-investment risk**

The possibility that if you invest in fixed rate investments (eg. bonds) you may have to re-invest maturing money at a lower rate of interest if rates generally decline during the life of that investment.

**Liquidity risk**

The possibility that you may not be able to readily access your funds when you want or need them most because they are invested in illiquid assets (eg. real estate).

**Credit risk**

The possibility that an institution holding your capital (eg. a debenture issuer) may fail to pay interest or return your capital.

**Regulatory risk**

The possibility of government policy changes negatively affecting your financial strategy (eg. superannuation and retirement incomes policy).

**Timing risk**

The possibility that a strategy of trying to time entry and exit from markets will expose you to greater short-term volatility.

**Value risk**

The possibility you will pay too much for a particular product or that you will sell it too cheaply.

**Manager risk**

The possibility that you will invest with a fund manager based primarily on their recent past performance without regard to their fundamental ability to cater to your particular needs or performance expectations over the time frame you have in mind.

**Currency risk**

The possibility that investments held in other countries may rise or fall in value due to the relative value of the currency they are held in to the domestic (Australian ) currency.

***How should you explain investment risks?***

4.3 FPA suggests that advisers include a separate section on investment risks in written recommendations. Members using other formats need to be satisfied that a client is made aware of these disclosures. The disclosures should (as a minimum) address the following issues:

- the historical relationship between investment risks and investment returns as it relates to the specific investment recommendations made to the client (while cognisant of the fact that past performance is no guarantee of future performance).
- the material investment risks (and rewards) which the member reasonably believes the client can anticipate if they accept the investment recommendations.
- the provision of clear understandable communications to assist properly informed decision making by the client.

4.4 If investment recommendations are provided orally to the client then members would likewise disclose orally the information outlined in Rule 111 and 4.3 above

4.5 Examples of statements aimed at explaining various investment risks appear in the Appendix to this Guideline. The FPA stresses that these are generic examples aimed at providing members with an indication of the types of explanations that could be used to explain various risks to clients.

4.6 Material Investment risks associated with any recommendation must be explained in terms that the particular client is likely to understand. This places the onus on the member to ensure that their explanations are tailored to each particular client and that technical jargon does not obscure the need for plain English. Clients for whom English is not their first language and clients who do not have investment experience have different communication needs which financial planners may need to address.

4.7 FPA acknowledges the use of tabular and graphic illustrations as tools to assist its members explain material investment risks to their clients. However these illustrations are best used in support of (not in place of) the member's written explanation of material investment risks.

4.8 FPA supports the provision of educational/explanatory materials to clients and has developed (in conjunction with Macquarie Investment Management Limited) a booklet titled "Understanding Risk to Achieve your Financial Goals" which is available from the FPA. Educational materials can extend client appreciation of risk/reward trade-offs so that a better informed approach to investment decision making occurs.

4.9 General explanation of the types of investment risks associated with specific recommendations may be accomplished by reference to an

educative source such as the FPA/Macquarie booklet mentioned above. This does not reduce the onus on a member to identify the particular investment risks associated with the specific recommendations. Members who employ reference sources like the FPA/Macquarie booklet should include a warning that the booklet gives a general explanation of risks only and not an explanation specific to that particular client's investment objectives, financial situation and particular needs.

## 5. Review of this Guideline

5.1 FPA Practice Guidelines require review to ensure their continued relevance to members and their businesses. Given the potential for CLERP law reform in this area, this Guideline will be reviewed after 12 months.

## Appendix

## Examples of Statements Explaining Investment Risks

The following are examples of statements used by practising financial planners to explain various investment risks to their clients. Rule 111 requires members to explain investment risks having regard to the particular client's circumstances they are dealing with at the time, hence these examples may not be appropriate to every client.

The explanation of investment risk will vary according to whether a reasonable person in the client's position would consider the risk to be significant.

**Example 1**

Scenario: An investment strategy involving the use of **borrowed funds**.

Explanation: Borrowing money to invest is known as "gearing".

Geared investments are generally designed to increase overall returns while increasing the potential for tax deductible expenses (such as prepaid interest). The ultimate goal of this strategy is usually for the value of the assets purchased with

borrowed money to increase and create a profit upon sale, after repayment of borrowed funds plus expenses.

The main risk associated with such a strategy is that the asset you purchase with borrowed funds will actually fall in value, even to the point where selling the asset doesn't completely satisfy the underlying debt. This will mean that, although you might receive extra tax deductions over time, you might actually lose capital (and carry over a significant debt) when you eventually sell the asset.

The potential to make a higher gain by borrowing exists only because of the added risk you take in using borrowed funds in the first place.

**Example 2**

Scenario: An investment strategy which involves the **re-financing of home mortgage debt**.

Explanation: The strategy recommended involves re-financing your home mortgage. The equity you currently have in your house will fall as the amount you owe on it increases.

The additional monies obtained by re-financing will be used to pay out your current mortgage, pay our fees and invest the balance. You will therefore be **increasing** the level of debt owed on your house in order to make an investment elsewhere.

The rationale of this strategy is to increase and diversify your asset base and obtain a tax deduction while you repay the additional loan monies used to make the investment.

The main risk you expose yourself to in taking up this strategy is that the value of the investment will actually **fall** and that ultimately you may have to sell that investment at a loss.

If this occurs, you may lose the equity in your home. You may even lose your home.

**Example 3**

Scenario: An investment strategy which involves complete or substantial asset allocation into **cash**.

Explanation: If your other investments in fixed interest, shares and property drop in value over the next few months it may be prudent to have retained some of your funds in cash. This would enable

you to invest the cash back into your main portfolio of growth assets when the entry price is lower.

However the market may continue to rise while your cash is out of it. Consequently, you need to choose whether you prefer to retain some of your funds in cash and possibly reduce volatility or stay invested and possibly get higher returns with the risk of fluctuating value.

**Example 4**

Scenario: An investment strategy which involves complete or substantial asset allocation into **fixed interest products**.

Explanation: Investing in fixed interest products should provide higher income than cash in the long run and perhaps the prospect of a small capital gain if interest rates fall.

However, fixed interest investments can also drop in value when interest rates rise. Another investor will be able to buy your fixed interest investment for less than its face value when rates have risen because their alternative is to buy a new one at a higher interest rate.

For the same reason they will expect to pay more for yours if rates fall.

**Example 5**

Scenario: An investment strategy which involves complete or substantial asset allocation into **real property**.

Explanation: Investing in direct property can potentially provide rental income and capital growth over the long term. Direct property can fluctuate in value and sometimes this fluctuation can be significant.

The main risk when investing in direct property is a lack of liquidity (or market depth). Should it become necessary to sell direct property there may not be buyers available who are prepared to meet your selling price. You may therefore have to hold onto your property or sell it at a lower price.

Property investments when used in conjunction with other classes of investment like equities and fixed interest can provide diversity which may actually smooth out risk for the total portfolio.

**Example 6**

Scenario: An investment strategy which involves complete or substantial asset allocation into **domestic shares**.

Explanation: By investing in Australian shares (equities) you should receive income from company dividends and some of these may have imputation tax credits. In addition to providing an income your share investment may rise in capital value over time.

However, there is also a risk that the value of a share may fall and that its dividend may fall or in some years not occur at all.

It is therefore important to avoid investing in only one sector of the equities market (eg. mining and resources shares). A balance of investments across sectors of the equities market is one way to reduce the chance of making a loss in the equities market as a whole.

Of course, there is also the risk that the market as a whole may fall (as occurred in 1987 and 1994) and then take some time to recover.

That is why growth investments (such as shares) should usually be **balanced** by investments in other sectors, such a cash, fixed interest and property.

**Example 7**

Scenario: An investment strategy which involves complete or substantial asset allocation into **international shares**.

Investing in international shares (equities) provides access to the other 98% of the world's stock markets - Australia represents less than 2% of the world market. They behave in a similar way to Australian equities, though do not provide imputation credits.

On top of the risks already described at example 6, above, international share values held within Australia are also subject to the risk that currency fluctuations will reduce their value.

For example, if you have an investment in US equities and our currency loses value relative to the US dollar, your investment would be worth more in Australian dollars. However, the reverse would also be true if our currency gained value relative to the US dollar.

Some fund managers use currency hedges and other strategies to partially or completely address the risk of adverse movements in the currency markets.

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