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Private Asset Management Ltd

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DIGGING THE DIRT ON DIMS – Part 2

This week we continue our deep dive into Discretionary Investment Management (DIMS) and today we focus on the downside risks of the service, from the client perspective. Signing up to a DIMS agreement is a big step for a non-expert retail investor and the Financial Markets Authority (FMA) is concerned enough about the risks involved to announce a few weeks ago that it is carrying out a DIMS sector risk assessment: "This involved a survey of 55 DIMS providers, licensed to provide services to retail investors. Our questions considered risks inherent to DIMS and were designed to understand how providers governance, culture, policies, processes, systems and controls are used to meet compliance obligations and achieve positive investor outcomes. Our review of survey responses suggests there may be some gaps in their interpretation of obligations and conduct that may negatively impact investors. Areas of specific focus include risks relating to conflicts of interest management, excessive portfolio turnover, inappropriate position limits and benchmarking, misclassification of services, and lack of controls around financial advice. Our next steps will be to monitor DIMS entities in consideration of the risks we have identified."

Although it's sometimes almost as difficult to interpret the thinking of the FMA as it is to predict the next move in interest rates from reading the minutes of the latest Federal Reserve meeting it is reasonably clear from the above that the Regulator has looked at the activities of the 55 licensed DMS providers and seen some behaviour that they are not happy with. My take on the above, having regard to what DIMS providers actually do, via the window afforded by substantial shareholder disclosures, is that "conflicts of interest" are the foremost "risk inherent in DIMS that may negatively impact investors".

By email, I asked the FMA what were the major conflicts of interest they were concerned about. Channeling the Fed, the FMA said, "conflicts of interest are common within DIMS and may include the services of related parties. Whatever the conflict, providers need to ensure that they are disclosed to investors and the FMA". So what are the major conflicts of interest that your typical DIMS provider "must manage and disclose" to its clients? As usual these mainly involve the fund management and investment banking businesses, typically also owned by a DIMS provider. The fund management conflict is obvious – if you deal with the private wealth division of a big bank they are likely to direct you to their wholly owned fund management arm. The investment banking (IB) conflict and its impact is less evident. The IB arm of a bank, stock broker or financial advisory firm makes its money by promoting itself as an organisation that can distribute a third party's product to its clients. For example when there is a new company considering floating on the stock market, like My Food Bag or Meridian for example, the various investment banks will endorse themselves highlighting their DIMS funds under management, market share of NZX activity, number of clients etc on the basis that "we can effectively sell your shares to our clients". Nothing to see here except that the overall institution is acting for both sides of the deal: the seller who wants to maximise their sales price and the buyers who have the opposite objective. It is not immediately obvious how this conflict might be "properly managed". Investment banking is not just limited to shares – there is lots of business done in the primary debt market whereby companies sell their bonds to a range of investors. Whilst again this might look unremarkable the reality is more nuanced: As a general rule high-risk bonds are sold whereas lower-risk bonds are bought: In NZ unrated debt issues pay commission and underwriting fees to banks and private wealth managers. They, in turn, undertake to sell these bonds to their clients, particularly their discretionary investment management clients who are regarded, unofficially, as sub-underwriters. The main impact is that clients of firms with an IB division typically have higher weightings in unrated debt and are overweight IPO's underwritten by that firm's IB division.

There is considerable evidence that, despite extensive disclosure regimes, conflicted investment advice continues to negatively impact investment outcomes both locally and overseas. In 2015 President Obama's Council of Economic Advisers (CEA) looked at the effects of conflicted investment advice on retirement savings and just in respect of Individual Retirement Accounts, which are similar to our KiwiSaver plans, it concluded that the total cost of conflicted advice was approx. US$17bn each year. The CEA concluded that savers receiving conflicted advice earned returns roughly 1% lower each year. The DIMS market is dominated by institutions whose advice is conflicted with the result that, with $42bn in DIMS, the cost of conflicted advice in NZ could be around $400m per year.

The big issue here is to what extent, if any, do DIMS managers deviate from best practise as regards portfolio management by directing clients assets to their own fund management businesses and to fulfil the distribution requirements of their investment bank? The FMA seems to favour private chats with conflicted players so we have no information as to what its policy on these issues are but all the anecdoctal evidence I see suggests that these conflicts of interest are tolerated and most certainly their impact is not disclosed fully to clients. For example, the bond component of a DIMS portfolio I reviewed the other day had a 50% exposure to non-rated debt. High risk bond portfolios like this are totally inconsistent with best practice, as represented by the strategies of pension funds both locally and around the world and likely was a function of the investment banking obligations of the broker concerned.

The FMA's solution to these problems is "disclosure" and whilst this is consistent with the actions of other regulators my view is that it is unsatisfactory. The outcomes are certainly not satisfactory. Back in June 2019, in an article entitled "Ordinary Investors No Match For Experts", we looked at the disclosure issue. That story referenced a research paper prepared for the Australian Banking Royal Commission by Professor Sunita Sah. Sah's paper for the predictably concluded that "in much of the research presented in my report the effect of the conflict of interest on the quality of advice was much greater than any of the mitigating policies such as disclosure. This highlights the importance of kerbing conflicts of interest rather than simply managing them. Realigning incentives for advisors to eliminate conflicts of interest will have a much larger effect than disclosure in encouraging high quality, unbiased advice."

So why doesn't disclosure work? There is a large body of research[1] which shows that firstly, individuals generally do not discount advice from biased advisors as much as they should when conflicts of interest are disclosed. The research suggests that after disclosure individuals tend to trust the discloser more rather than less. Secondly, advisors who disclose are often tempted to provide more biased advice in order to counteract the impact of the disclosure. Advisors feel morally licensed to bias advice even further than they would without disclosure eg caveat emptor. Disclosure thus offers an attractive and profitable alternative to eliminating the conflict of interest. Research however has found that disclosure does work if the disclosee is an expert. This is a little perverse because disclosure ostensibly is designed to protect unsophisticated investors from exploitation, not experts.

Why then, given it doesn't work, is disclosure the preferred option both locally and around the world? Perhaps because it is an ideal solution for both regulators and the finance sector. It allows regulators to be seen to be doing something without actually doing anything or upsetting anybody, thereby potentially safeguarding their career prospects within the industry. It obviously suits the finance sector because, for all but expert recipients of disclosure, it doesn't work, thereby preserving industry profitability.

[1] The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest, Restoring Rational Choice: The Challenge of Consumer Financial Regulation, Consumer Protection Takes More Than Transparency.