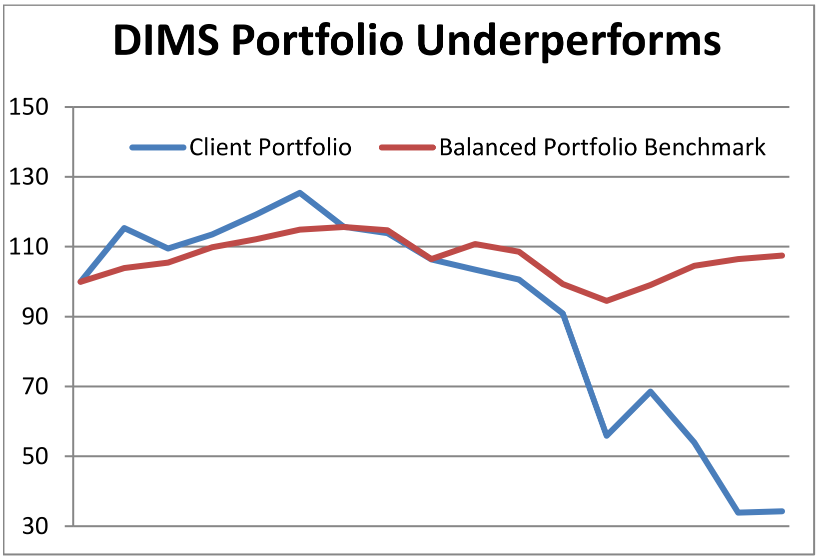
WEEKLY REPORT OCTOBER 2023

Private Asset Management Ltd

Brent Sheather is a Financial Advice Provider and a personal finance and investments writer.

DIRTY DIMS DONE DIRT CHEAP – Part 3

A few years back I was employed as an expert witness in the preparatory work ahead of a possible court case, on behalf of a trust which was a client of a large stock broking firm. The trust had a substantial portfolio and its objective was "to preserve and increase the value of the assets". We interpreted this as meaning that a balanced portfolio with an asset allocation of around 40% bonds and 60% growth assets would have been appropriate. The trustees' had a number of concerns not least of which was the performance of their portfolio. As part of my work for the clients' legal team I produced a graph of how their portfolio had performed relative to that of a composite benchmark index with the same weightings in each asset class as the clients' portfolio.



Source: Private Asset Management

The graph adjacent shows that over the 4 years that the investments were managed it sustained a loss of about 65% versus a gain of 8% for a representative benchmark. Using this comparison we calculated the extent of the loss suffered by the client due to the stockbroker's management and that was the basis of the claim for damages.

What makes this sorry episode relevant to the last two stories on DIMS is that, as the clients were resident overseas and had no knowledge of investment markets, they decided to let the broker concerned manage their portfolio on a discretionary basis. Today we will outline some of the dirty deeds done to the clients' portfolio and thus provide a practical insight into the downside risk of DIMS. As highlighted in previous stories, these risks primarily involved conflicts of interest together with a liberal dash of high risk investing.

I should state at the beginning of this story that the only reason I got the job as an expert witness is because the lawyers involved could not find anyone else in the stockbroking world who was willing to go on the stand and criticise the broker concerned. At the time the lawyers commented that this was a huge indictment of our industry and the subsequent exchanges between the stockbroking firm and their expert witness brought home to me that they really had no knowledge of what best practice looked like. Indeed, their management of the portfolio seems to focus solely on the pursuit of returns without regard to risks.

The fundamental basis of the action, was that the DIMS management employed over the four-year period was absolutely at variance with best practice. Best practice was defined as the investment strategies, as regards both risk and return dimensions, typically employed by a professionally managed portfolio like a pension fund, with the benefit of independent, expert trustees. Not only was the management of the portfolio at variance with best practice there were many stock positions where the weightings exceeded the rules set out in the stockbroker's procedures manual. It was a real sh_t show but, like most horror stories involving the financial sector, this one was not without irony – one of the senior executives in the stockbroking firm concerned was on the Disciplinary Committee of the NZX.

So what were the big reasons for the poor performance of the portfolio relative to the benchmark? Most appeared to be a function of various conflicts of interest which the broking firm wasn't able "to manage" (using the FMA's terminology). Probably the biggest issue was that when the broker took control of the portfolio it had a very large position in a small company. This was acknowledged as risky by all parties but despite that and the fact that the portfolio was managed on a discretionary basis little effort was made to diversify. Its subsequent downward spiral severely impacted overall performance. Why was there no action? There were two reasons in my opinion: firstly the broker focussed on returns and paid little attention to risk. No plans were formulated to diversify and various reasons were given for retention including " our research indicates that the shares are undervalued". Secondly because the brokerage firm had an investment banking relationship with the small company it may have been reluctant to see the market price fall as it reduced the holding, possibly due to concerns that shareholders in the company might have received a margin call if the stock fell below a certain price. Note this was just speculation on my behalf at the time.

Next up we look at asset allocation and instrument selection and again conflicts of interest were evident. Despite the client having an average risk profile the bond component of the portfolio contained only high risk, unrated debt and many of these issues had been underwritten by the investment banking arm of the broker. There was little or any consideration of asset allocation and the only reference to the topic was that the portfolio could be invested 70% - 100% in NZ shares and 0 - 30% in cash i.e. totally at variance with the asset allocation of a typical balanced portfolio at the time. A feature of the brokers discussion of asset allocation was to permit a large range of positions. In the FMA's latest bulletin on DIMS the regulator notes this as an issue and in an email said "DIMS providers need to define the percentage allocation to various asset classes within their Investment Authority. Some providers set asset allocations that accommodate anything between 0 – 100% within each asset class, which provides managers with a lot of flexibility, but they need to ensure this aligns with investors long term objectives."

There was so much wrong with the management of the portfolio – my report was about 10 pages long - but the structure of the property section of the portfolio provides another illustration of the conflicts present and how they dominated investment strategy. Almost one third of the property portfolio exposure was invested in one of NZ's smallest property companies, which at that date accounted for approximately 1.7% of the NZ Stock Exchange Property Index. No professionally managed fund would countenance a twenty times overweight position like this. Needless to say it was a terrible performer for the trust but the significant point was that the broker was an underwriter when the company floated on the NZX. The broker was using the client's portfolio, and presumably that of other clients, to sub-underwrite the operation of their investment banking arm i.e. any new issues they weren't able to sell they placed into DIMS clients' portfolios.

After discussions between the two legal teams the stock broking firm settled with the client, precluding any court action, any record of the disaster and attendant bad publicity.

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.