Cuffelinks
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This Week's Top Articles

- **The Harry Markowitz Interview, Part 1: Portfolio Selection**
- **Bring on the Council of Superannuation Custodians** *Graeme Colley*
- **Peering into peer risk** *Jack Gray*
- **Why accounting may finally be sexy** *Andrew Gale*
- **APRA confirms SMSFs as retail but public funds stranded** *Graham Hand*
- **Has APRA also delivered a blow to SMAs?** *Graham Hand*

The Harry Markowitz Interview, Part 1: Portfolio Selection

At the 2013 Research Affiliates Advisory Panel meeting in San Diego, I interviewed one of the fathers of the wealth management industry, the 1990 Nobel Prize Winner, **Harry Markowitz.** His 1952 seminal paper *Portfolio Selection* pioneered our understanding of risk, return and correlation in investment portfolios. His Efficient Frontier and Modern Portfolio Theory ideas are still taught in universities and business schools.

Harry Markowitz was born on August 24, 1927 in Chicago. He studied economics at the University of Chicago under important economists, including Milton Friedman. While still a student, he was invited to become a member of the prestigious Cowles Commission for Research in Economics, leading to his 1952 breakthrough work.

Markowitz now divides his time between teaching (he is an adjunct professor at the Rady School of Management at the University of California at San Diego) and consulting (out of his Harry Markowitz Company offices). He is co-founder and Chief Architect of GuidedChoice, a managed accounts provider and investment advisor. Markowitz's more recent work has included designing the software analytics for the GuidedChoice investment solution and heading the GuidedChoice Investment Committee.

One amusing moment from the Conference shows how competitive and bright the 85-year-old Markowitz still is. The 2011 Nobel Prize winner, Chris Sims, had just finished a highly technical presentation on how fiscal policy affects inflation. As he paused for questions, Harry was first in. "Now we know how you got your Nobel Prize, let me show you how I got mine." And he gave his critique of the presentation as if giving a lecture in his university.

Graham Hand: I'd like to start by going back to 1952 and your seminal paper, *Portfolio Selection*. Did the idea of mean variance and efficient frontier and risk reward come to you while you were having a shower, or was it more systematic that that?

Harry Markowitz: There was a moment of truth, a 'ah ha' moment. Let me give you some background. I was a PhD candidate at the University of Chicago and had to choose a topic, so I went to see my supervisor, Professor Jacob Marschak. He was busy so I sat in this ante room, and another man was there who was a broker. He suggested a dissertation on the stock market. That's the best advice a broker has ever given me.

I suggested this to Marschak, and he said Alfred Cowles (who set up the Cowles Commission at the University) had always hoped people would do that. Cowles was one of the first to study how successful stock pickers were (and he found they weren't), his work became part of the development of the S&P500 index, but he was also a scholar. Marschak did not know the relevant literature so he sent me over to Professor Marshall Ketchum. He was Dean of the Business School at the time. He gave me a reading list which included Graham and Dodd, Weisenberg and John Burr Williams, *The Theory of Investment Value,* from 1939.

So I'm in the Business School Library, and Williams says the value of a stock should be the present value of its future dividends. I thought to myself, dividends are uncertain, so he must mean the expected value. So I thought if we're only interested in the expected value of a stock, we must be only interested in the expected value of a portfolio, but to maximise the expected value of the portfolio, you must put all your money into the one stock with the highest expected return.

But that can't be right, everyone knows you should not put all your eggs in one basket, Weisenberg had shown people are willing to pay for diversification. So people diversify to reduce risk and volatility, and standard deviation is a measure of risk.

GH: So you knew statistical theory, you had that background?

HM: Yes, I had the usual courses you'd expect from an economics major in the leading econometrics school. So I visualised the returns on the securities as random variables, so that means the return on the portfolio is the weighted sum of the returns on those random variables. I know what the expected value of a weighted sum is, but I don't know off hand what the variance of a weighted sum is. So I get a book off the library shelf, *Introduction to Mathematical Probability*. I look up the formula for the variance of a weighted sum and there it is, <u>covariance</u>. Not only does the volatility of the portfolio depend on volatility of the individual securities, but the extent to which they go up and down together.

GH: That was the magic moment.

HM: That was the moment. So now I have two quantities, risk and return, and I know economics so I draw a trade-off curve. I'd heard of efficient and inefficient allocation of resources, Pareto optimums and so on. So I now had efficient and inefficient portfolios. In that flash, in that moment, much of Markowitz 1952 came together.

GH. So although there was this moment, there was a massive body of knowledge already built up.

HM. Sir Isaac Newton said, "I saw so far because I stood on the shoulders of giants."

GH: Also in your career, you are credited with running one of the first hedge funds, doing arbitrage.

HM. No, a long way from the first. A bit of history. My first job out of college was with the Rand Corporation, where I developed a programming language called SIMSCRIPT, for simulation. The guy who wrote the manual was an entrepreneurial-type, he said, "Harry, let's form a company." We founded CACI in 1962, it still exists, it's a big company now. Then UCLA invited me to be a full

professor, full tenure, and another entrepreneur decided to form a hedge fund called Arbitrage Management, based on Thorp and Kassouf's book, *Beat the Market*, doing all sorts of arbitrages. I was a consultant, then the portfolio manager. We made a decent return for clients but not really for us, we were generating a lot of brokerage, so we became a wholly owned subsidiary of a brokerage house before I left.

GH: Given it's now 60 years since *Portfolio Selection was published, d*o you feel any sense of disappointment about our profession, we haven't really had any major breakthrough theory of investing since the 1950's.

HM: A lot has happened. We have a lot of data now. In 1952, we hired a student to collect data on securities. But between the top down view, knowledge of data, and our experience, we are better now. When I was at Rand in 1950, I just did 50/50. That's all I knew then, it's not what I would do now and it's not what I would recommend to a 25 year old. My profession and I have learned a lot.

GH: I don't like how so many investment discussions end up talking in generalisations.

HM: It's a good point. There's a big difference between my article of 1952 and book of 1959. In chapter 13, I talk about the division of labour between the computational part and the intuitive part. Computational part can show probability distributions of returns you can have at your disposal, we can tilt them so they're correlated with inflation or whatever. But which particular probability distribution you want to have at this time of your life, for this year – you know, your kids go to college, you're not feeling well, people might be dying in your family, etc - is beyond any model. We don't understand all that goes on. If we could understand it, we couldn't model it. If we could model it, we couldn't estimate it. This year is different from next year.

Next week: Harry Markowitz on providing retail financial advice.

Bring on the Council of Superannuation Custodians

Graeme Colley

Governments of all political persuasions have a problem; trustee confidence in the superannuation system is declining. There is no shortage of anecdotal evidence to support this, just read the 'Letters to the Editor' columns in any newspaper or listen to talk-back radio. But it's not just anecdotal evidence, as two recent surveys quantify this lack of confidence in the system.

The first survey was the SPAA-Vanguard report released late last year. The actuarial firm Rice Warner was engaged to undertake a 69-question survey to identify the financial needs of SMSF trustees and review their general concerns about retirement. A key finding that emerged from the 384 trustees who responded was quite revealing.

They said legislative change was the 'biggest risk' to retiring comfortably retirement, with 83% listing it as 'their biggest concern'. What people want from government is certainty about the rules governing their retirement savings, and this survey clearly indicates they believe they are not getting it. Quite the contrary. What government is doing with the rules of the game is more likely to keep them awake at night than their investment portfolios.

It was the same outcome for the survey SPAA released in conjunction with Russell Investments. *Intimate with Self Managed Superannuation* – the third benchmark study into Australia's rapidly growing SMSF sector – was conducted by the independent research firm CoreData which surveyed 1,555 Australian consumers of whom 437 were SMSF trustees.

In terms of confidence in the system, the outcome largely mirrored the earlier report. It was waning, although SMSF trustees were less pessimistic than APRA fund members. Constant government change to the superannuation system was identified as a key reason behind this lack of confidence.

The findings of these surveys have resonated through the SMSF industry. The anecdotal is now hard evidence. It's in this context that the announcement on 5 April 2013 by the Minister for Financial Services and Superannuation, Bill Shorten, in which he promised to set up a Council of Superannuation Custodians, has to be seen.

It's worth quoting Shorten in full:

"The Government will establish a Council of Superannuation Custodians to ensure that any future changes are consistent with an agreed Charter of Superannuation Adequacy and Sustainability.

"The Charter will be developed against the principles of certainty, adequacy, fairness and sustainability. The Charter will clearly outline the core objects, values and principles of the Australian superannuation system.

"The Council will be charged with assessing future policy against the Charter and providing a report to be tabled in Parliament."

There's no shortage of motherhood in those fours sentences. Some observers greeted the concept of such a Council with a degree of cynicism. But across the industry – whether it was SMSF, retail, industry or public sectors – there was broad agreement on the concept of such a council.

It appeared to indicate that the Government had finally recognised that all the media speculation surrounding possible changes to the tax treatment of superannuation in the weeks preceding the 5 April statement had taken its toll on the system and it was time to take some of the political heat out of the debate. A proposal to set up a Council was a sound starting place.

It's been the industry's contention for some time that the continual changes to superannuation and, more importantly, the tax regime around it, were undermining our universal system. It seemed from our vantage point that the original goal of superannuation that both sides of politics signed up to – giving the people the opportunity to be self-sufficient in retirement – was being lost in a debate about the equity, or otherwise, of the tax concessions.

Equally worrying was the increasing tendency by government to see superannuation as a revenue measure to meet other spending commitments – a honey pot that keeps growing exponentially.

Since the Minister's statement, and the immediate media flurry, discussion about the Council has largely dried up. In my opinion, that's a pity, because there are some critical questions to be asked about how this Council will work. Would it reduce the political point-scoring and elevate the policy debate? Would it give people more confidence in the system?

The Minister was short on details, but it seems a step in the right direction to have a principles-based charter. Any future changes to the superannuation system would then have to be assessed against them. Reporting to Parliament seems another positive. I suspect Shorten believes it would strengthen the Council's arm and, at the very least, should make it harder for the government of the day to blithely ignore its deliberations.

Who would sit on the Council would be critical. The Government blurb said 'eminent representatives from the community, industry and regulators'. Hard to argue with that stated aim, although it must be said all governments do find it difficult to keep politics out of appointments. But it is possible. The Reserve Bank board is a good example of where the members' political sympathies seem largely irrelevant.

It's impossible to remove superannuation from the political debate. Nor should it be. In a parliamentary democracy such as ours, a public policy as important as superannuation should be

vigorously debated. No one, including the Minister, believes the system can be totally politically neutered.

Rather, a Council working properly would have the capacity to debate issues, to offer alternative thinking to that coming out of the federal bureaucracy in much the same way as the Productivity Commission does now on important economic issues. By doing this it could lay the groundwork for more constructive public debate.

At the very least it would give trustees, the cornerstone of our system, greater faith that the principles underpinning the system are adhering to 'certainty, adequacy, fairness and sustainability'. That has to be an improvement on what we have now.

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Peering into peer risk

Jack Gray

"Rank among our equals is perhaps the strongest of all our desires." Adam Smith, c. 1780.

Two linked factors explain and justify our concern for rank relative to peers, one largely psychological and sociological, and the other primarily economic.

Our concern is so deep and persistent it is probably best explained in evolutionary terms. High status confers advantages in attracting mates, in acquiring food, in surviving. The Whitehall Study of British civil servants found that after controlling for all *known* relevant factors, high status civil servants live four years longer than low status ones. Our well-being depends on how others perceive us, on keeping up with the Joneses.

Fear of being wrong and alone

After leaving my role as a fund CIO, I saw the fund had scraped into the first quartile which, given its value bias in a growth period, was by all rational criteria a strong result. My visceral response to self, "why wasn't it higher up?" was by all rational criteria absurd. But biology is far from destiny; we can learn to moderate our impulses. A self-help *Peer Risk Anonymous* group might be laughable but the principle of seeking out others for support is a useful step in nudging us away from an excessive concern for peer risk. Smith's "strongest desire" varies across people so those who need a fix of peer-respect should seek support from those with a strong tolerance for peer risk.

The second more economic justification is that peer risk encourages adapting ideas from others, a process that can increase aggregate welfare. Mimicking other funds' benefit-enhancing activities in administration, custody, insurance and communication will serve members' interests, though not necessarily their *best* interests. In a strongly regulated industry mandated to manage people's retirement savings, the dominant business risk is the fear of being wrong and alone, which makes copying at the margins the dominant *modus operandi*, as it is in banking and insurance. That *MO* results in (far too) many essentially identical funds, a structure that may not optimise economists' utility functions but may *satisfice* society. By ensuring stability without sacrificing on-going marginal improvements, that structure may be both *satisfactory* and *suffici*ent. But it might not *best*-serve members' interests because it is exposed to opportunity cost and vulnerable to the risk of disruptions from new entrants (think SMSFs) or new technologies (think internet banking) that can end in Jurassic-style destruction.

Investing is different. There's a strong aversion to peer risk among investment managers generally and the consequent strategy of mimicking is dangerous. Dangerous because there is little evidence that rankings of superannuation funds by agencies such as Mercer or ChantWest influence members' or employers' investment decisions. Maybe they've absorbed the industry's shouting about past performance. Dangerous because surveys focus on neither the longer-term nor on risk-adjusted performance. Dangerous because a strategy under-performing in the shorter-term may be well-placed to out-perform in the longer-term. Dangerous because differing from rather than copying the market is necessary to beat it.

Reducing peer risk creates other risks

Investment strategies crafted largely to keep up with the Joneses, and to lower peer risk, create new risks. One such risk arises when small funds mimic strategies in private markets where large funds have non-replicable advantages in information and in the power to better align fees. Another arises where funds mimic only after a strategy has been successful, by which time altered market conditions or capacity constraints may lead to significantly lower future returns. Copying another fund's active strategies can suffer from both these risks, as occurred with US endowments' rush to be like Yale. The boring 60/40 equities/bonds strategy has now outperformed all but a handful of the early sophisticated endowments.

Mimicry can also require skills and capacities funds may not have. Some Australian funds believe they can mimic hedge fund and venture capital programmes, over-riding the insight that both are fast-moving, local, network-driven and demand a strong presence in the incubating areas of New York and London for hedge funds and Silicon Valley for venture capital. Even mimicking a passive listed equity strategy has elements of that risk. One fund that believed all it needed was a tame quant, a powerful computer and a live feed developed such a poorly constructed index fund that it underperformed by an outrageous 100 basis points.

Notwithstanding these risks we all suffer from peer-risk-induced performance anxiety, even sophisticated contrarian investors. US endowment funds do, sovereign wealth funds do and pension funds do. Beyond Adam Smith's claim lies a more subtle contributing explanation. Most industries and professions have broad agreement on reasonable, evidence-based principles or theories on which they base their practices. Investing largely lacks these. Theories are weak, agreed principles are compromised by arbitrage, data is poor and uncertainty rather than risk rules, OK? That leaves the 'Comfort of Crowds' as a not unreasonable way of assessing what one is doing, an assessment made even more reasonable if courts take 'industry standards' as a benchmark for prudence.

Do you really have a tolerance for peer risk?

The barriers to reducing our aversion to peer risk are highlighted by a (not-so) hypothetical. Your fund's objective is to generate '3.5% pa after inflation over the long-term with moderate levels of risk.' With global 30-year inflation-linked sovereign bonds yielding 4% real, should you allocate massively to them because they meet the return objective (plus a margin) and effectively have neither credit risk nor inflation risk (ignore the unfortunate requirement to mark-to-market)? As you and your fund have a declared strong tolerance for peer risk, you do that even though your peers eschew that opportunity in favour of equities. Then 30 years hence and your peers' funds have ridden an equity bull market and generated returns of 6% real leaving your fund meeting its objectives but languishing in the bottom decile. Do you and your fund retain a strong tolerance for peer risk? And do investors reward you for exceeding your fund's objective?

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[Accounting may finally be sexy]

Andrew Gale

Accountancy practices have been a poor second cousin to financial planning businesses in terms of sale price and merger and acquisition (M&A) activity. Here's why that might change soon.

Accountants enjoy a strong position as trusted advisers, and are increasingly becoming SMSF experts. Many are also broadening their services to include financial advice, and growing holistic services. The result? Increased recognition of the potential of accounting practices, leading to increased M&A activity and greater goodwill recognition. A golden era for accounting practices (and their Gen X and baby boomer principals) may well be emerging.

In this article, I put the case for increasing accounting firms' values, due to:

- the increasing involvement of accounting practices in financial services and advice
- the recognition of the latent value of accounting practices, with their attractive client lists and relatively low financial planning (FP) penetration
- their special positioning with clients as trusted advisers.

The following observations are based on trends and themes in recent M&A activity.

Historic multiples and valuations

In transaction terms, on a simple revenue multiple basis, accountancy practices typically trade at 70c-$1.10 per $1 of annual revenue, whereas FP practices trade at 2.5-3.5 x annual revenue. On the increasingly common EBIT basis for establishing valuation of practices, accountancy practices typically trade at 3.5-5 x EBIT (depending on a whole range of variables), whereas FP practices trade at 5-7 x EBIT.

Why the relative discount for accountancy practices? Is it because accounting firms are fundamentally less profitable than FP practices? Is it because the revenue or EBIT growth profiles of the respective businesses are fundamentally different? Or does it reflect the traditional custom that accounting firms have been the typical acquirers of other accounting firms and paid little for goodwill? The latent potential makes them attractive and potentially undervalued, and the M&A metrics for accountancy practices are now shifting.

Strong fundamentals

Accountants enjoy a special and privileged position with clients. For small to medium enterprise (SME) clients, accountants are the first port of call for financial matters including financial advice, SMSFs, and loans. Accountants are particularly well-positioned given their strong knowledge of the clients' financial affairs, the structure they use including family trusts, their knowledge on optimal tax structures, and their access to financial statements (especially useful for lending services and intermediation).

There are a range of issues and current industry developments which reinforce the role of accountants, including:

- The strong ongoing growth in the SMSF sector, with the next waves being Gen X clients, post retiree clients and clients seeking a co-navigation and coaching advice model. Accountants are the gatekeepers to these SMSF client relationships.

- The removal of the accountants' SMSF exemption and the introduction of an SMSF limited licensing regime (with a three year transition period from July 2013). Current estimates are that up to 8,000 accountants may become licensed, with a healthy portion likely to opt for full licensing due to residual ambiguities in the limited licensing regime. This will only strengthen and extend the intensity of involvement with SMSF clients and financial advice.

- Following an extensive and intense three year consultation process with the Accounting Professional and Ethics Standards Board (APESB), a constructive resolution has finally been reached for a sensible professional standard, APES 230, governing accountants providing financial advice and services. There was the possibility that the original draft of this standard could have constrained financial advice services by accountants, damaged their business models, and driven the provision of financial of advice away from accountants. This would have been counter to the public interest.

- Whilst the Tax Agents Services Act (TASA) looks likely to apply to non-accountant financial planners from 1 July 2013, which will be pretty challenging, accountants are already well-positioned with respect to TASA.

- Anecdotally, an increasing degree of referral arrangements between accountancy practices and financial planning firms, including the arrangements being supported by the Institute of Public Accountants. The introduction of SMSF licensing requirements will only increase the degree of referral activity as some accounting firms decide to rely on referral arrangements to cover licensed activities.

Accounting and financial planning as natural partners

Typically, acquirers of accounting practices have been other larger accounting practices, either through merger or acquisition. These are often called 'tuck-ins'. Smart acquirers, which are already strong in FP, often look for accountancy practices with a relatively low level of involvement in FP so that the acquisition can be value-adding as FP is expanded in the acquired practice.

Four additional trends are evident:

First, accounting firms are seeking to acquire or merge with FP practices to extend their expertise in this area of service provision, and offer a more holistic client solution.

Second, FP firms want to acquire or merge with accounting firms in order to integrate services, and protect their clients from poaching.

Third, wealth management organisations want to acquire businesses which are strong in the accountant or SMSF sector. Examples include CBA's acquisition of Count Financial, IOOF's of DKN, Shadforth Financial Group's of Lachlan partners and others.

Finally, accountant aggregation plays such as Countplus and the recently announced Countplus 2.

Recent corporate activity has seen consolidation in the wealth management and financial advice sectors, with many non-aligned and independently owned organisations being acquired by institutions. It is likely that the future growth of accountants and their involvement in financial services and advice will see accountants at the vanguard of a renaissance in the independent financial adviser sector, as a portion of accountants will prefer to be independently positioned.

In the past, accountants acquiring or merging have typically done transactions with little recognition of the goodwill value or potential. Financial advice revenues are often less than 15% or 20% of the revenue base of many accounting practices, and for some it is close to zero, where even the advice provision to SMSF clients is limited to compliance services. This represents upside potential for accounting practices or potential acquirers of such practices.

The bottom line of all the above is increased recognition of the potential of accounting practices, more M&A activity, and greater goodwill recognition. A golden era for accounting practices is upon us – and accounting might finally be sexy.

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APRA confirms SMSFs as retail but public funds stranded

Graham Hand

Anyone responsible for product design and pricing in the superannuation industry needs an understanding of the revised Australian Prudential Standard (APS 210) on bank liquidity. There are implications for deposits placed with banks regardless of the maturity.

On 6 May 2013, APRA released its latest version of the bank liquidity risk management framework to apply to Australian banks (and other ADIs). The previous version was issued in November 2011, and has been the subject of heated debate in *Cuffelinks*.

As *Cuffelinks* is focussed on the wealth management industry, this paper is not a general summary of the proposals, which can be found here. Rather, we comment specifically on the implications for financial advice, investments, superannuation, SMSFs and portfolio construction.

The most important points are:

1. The Basel Committee recently announced it was allowing a gradual phase-in of the major liquidity requirements, delaying full introduction until 2019. However, APRA is sticking to the original timetable, due to the strength of Australian banks, with introduction of the Liquidity Coverage Ratio (LCR) on 1 January 2015, without any phase-in. Banks are already changing their products and pricing as a result.

2. After the November 2011 APRA release, there was conjecture about the favourable treatment given to SMSFs versus public superannuation funds. However, there was not much lobbying by the publicly-offered super fund industry and APRA has confirmed the previous advice.

   A reminder of what the issue is. The proposed Prudential Standard is designed such that deposits from large publicly offered superannuation funds will be considered volatile, wholesale money, against which banks will be required to hold expensive liquid assets under the LCR test. This will make the banks less willing to pay competitive interest rates on deposits from major public super funds. But SMSFs have been granted a special exemption which categorises them as retail deposits, giving them a regulatory free kick.

   This is **the most important point**, and the one made in my submission to APRA. Here is their exact response:

   "A number of submissions argued for amendments to the treatment of funds received via an intermediary as that treatment would result in differential outflow rates being applied by ADIs to an equivalent customer depending on the source of the deposit. This issue was raised, in particular, in relation to ***deposits received from SMSF customers rather than via APRA-regulated superannuation funds.****"*

   A clear statement of the issue. And this is APRA's decision (from the Discussion Paper):

   "For deposits sourced via an intermediary, where the intermediary retains investment responsibility or has a fiduciary duty to the underlying customer, ***APRA considers it is***

appropriate to assume the intermediary will observe the responsibility and duty in a time of liquidity stress. *This fiduciary duty is* ***not removed when customers have an investment discretion when initiating an intermediated deposit.*** *Accordingly, these deposits are most appropriately classified as being sourced from a financial institution, regardless of the nature of the customer placing funds with the intermediary. This interpretation will not affect SMSF deposits;* ***SMSF deposits are considered to be those of a natural person*** *and not sourced via an intermediary."*

This interpretation will not affect SMSF deposits, which are judged to be from a natural person and not sourced via an intermediary.

When *Cuffelinks* reported on this issue previously, some people claimed I had misunderstood, but APRA has made my interpretation clear. Banks will need to hold expensive liquid assets to support any deposit from a public super fund which matures within 30 days. This includes billions of dollars of at-call deposits placed in super funds in recent years.

3. APRA divides retail deposits into stable (with a 5% run-off assumption) and less stable (with a run-off assumption of up to 25%). SMSFs will be in the less stable category for the following reason:

   "A self-managed superannuation fund (SMSF) depositor is considered to be a self-selected, financially sophisticated individual who is undertaking an asset allocation investment choice.

   This activity is not consistent with the description of typical activity under a transaction account, as outlined in paragraph 36 (b) in Attachment A of APS 210. As a result, the deposit of an SMSF customer is to be categorised as less stable."

   But it will still receive the favourable retail treatment, and this should not be confused with the issue that a public superannuation fund is assumed to have a 100% run off inside 30 days.

4. The classification of superannuation funds as financial institutions while SMSFs are retail not only has implications for the calculation of the Liquidity Coverage Ratio (LCR), but also a longer term standard, the Net Stable Funding Ratio (NSFR). Again, any deposit classified as retail will qualify as a long term deposit, while those from a financial institution are more volatile short term. This is important because the NSFR treatment will apply to term deposit with maturities longer than 30 days.

5. There are other implications of APS210 for term deposit offers, especially on superannuation platforms which offer bank deposits. Here is APRA's view (Attachment A of APS210):

   "Retail fixed-term deposits

   The maturity of fixed or time deposits with a residual maturity or withdrawal notice period of greater than 30 days will be recognised (i.e. excluded from the LCR) ***if the depositor has no legal right to withdraw*** *deposits within the 30-day horizon of the LCR, or if early withdrawal results in a significant penalty that is materially greater than the loss of interest.*

   If an ADI allows a depositor to withdraw such deposits despite a clause that says the depositor has no legal right to withdraw, the entire category of these funds would then have to be treated as demand deposits."

   How will a public super fund which allows online withdrawals from all its products cope with this? With the development of platforms and wraps, most currently allow immediate access to both managed funds and term deposits, but this will need to be prohibited for term deposits in order to achieve the favourable liquidity treatment. Furthermore, this is not simply a matter of form over substance, and APRA has indicated it will test whether banks are actually giving early access even if the investor has no legal right. This is a bigger issue than simply a systems redesign, as it goes to the heart of access to funds via a platform, including switching and rebalancing facilities.

Timing and implications

APRA intends the new prudential standard to come into force on 1 January 2014, with the LCR on 1 January 2015 and NSFR on 1 January 2018. However, the consequences will be felt much earlier in product design and pricing, as banks move to adjust their funds transfer pricing systems to send the right signals.

Management of the LCR obligations will take many forms, but some early product responses include:

1. Offering a 'cash' deposit with a 31 day withdrawal notice period. This development has already surfaced, driven by the changing rules. For example, Investec has a product called a Liberty Notice Account that offers a higher rate and no fees provided 32 days withdrawal notice is given.
2. A superannuation fund could make an agreement with a bank not to call a deposit inside 31 days, but allow clients to access the funds 'at call'. This involves a maturity risk that would need careful management, such as holding a liquidity buffer to meet client withdrawals based on estimated net outflows, which would be tested by an unexpected run of short term withdrawals. In one conversation with APRA, this structure was not well received, and was called a 'device'.

Bottom line is that public superannuation funds offering bank deposits may face worse rates from the banks than retail deposits and SMSFs, and they will have to exercise their creativity to avoid a new product structure raising the ire of APRA.

Has APRA also delivered a blow to Separately Managed Accounts?

Graham Hand

There has been a significant move by many financial planning firms away from managed funds and into Separately Managed Accounts (SMA), sometimes called Individually Managed Accounts (IMA) or Direct Managed Accounts (DMA). These structures are designed to avoid some of the shortcomings of pooled managed funds, such as distribution to new investors of capital gains earned in prior periods. Also, cash managed funds cannot take advantage of retail 'blackboard specials', where banks issue term deposits to retail customers at attractive rates.

An SMA is a portfolio designed for a specific investor, with shares and other investments selected by a manager according to a model portfolio or other stock-picking technique. Shares are held separately in the name of the investor, so the pooling effects of managed funds are avoided. Reporting and tax outcomes are individually designed, with the investor as the beneficial owner.

These SMAs seek the best returns for their investors, and in the cash and term deposit market, the highest yields come from direct investment into banks, not into managed funds. For example, the wholesale 90 day bank bill rate is currently about 2.8%, but term deposits are still paying over 4%.

In the updated bank liquidity regulations released on 6 May 2013, APRA seeks to clarify the meaning of the term 'financial institution'. This is vital because deposits from financial institutions receive a less favourable liquidity treatment than sources identified as retail, considered the most reliable of funding sources for a bank.

APRA states (first in the context of responses to its November 2011 paper):

*"A number of submissions sought clarity on the definition of a **financial institution**, expressing concern that the definition in draft APS 210 was too broad. APRA has recently released Prudential Standard APS 001 Definitions, which includes a definition of financial institutions. Most entities*

noted as being financial institutions in the previous draft APS 210 are covered in that definition. APRA will use that definition in APS 210 but, for the sake of clarity, will make specific reference to money market corporations, finance companies, superannuation/pension funds, public unit trusts/mutual funds, cash management trusts and friendly societies."

So what exactly does Prudential Standard APS 001 Definitions say here (my emphasis)?

"Financial institution *includes any institution engaged substantively in one or more of the following activities – banking; leasing; issuing credit cards;* ***portfolio management (including asset management and funds management)****; management of securitisation schemes; equity and/or debt securities, futures and commodity trading and broking;* ***custodial and safekeeping services****; insurance (both general and life) and* ***similar activities that are ancillary to the conduct of these activities.*** *A financial institution includes any authorised NOHC or overseas equivalent."*

This definition could push MDAs, IMAs and MDAs into the financial institution bucket, reducing the opportunity for these structures to access retail deposit rates.

Furthermore, the catch-all "***similar activities that are ancillary to the conduct of these activities"*** could push the boundary even further, into Power of Attorney, general custody and any arrangement where the investment is made by an institution under a general instruction from a retail client.

Advice businesses which manage accounts on behalf of clients and rely on term deposits to improve returns should worry how far APRA pushes this revised prudential standard.

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