HORIZON
INVESTMENT SOLUTIONS

January 2019 — Over the Horizon Market Commentary by David Offer

For the Australian share market the new calendar year has started on a positive note. Over January, the All Ordinaries Index rose 228 points to close up 4% at 5,937 points. This positive momentum has continued into February with our market adding another 206 points (3.5%) at the time of writing.

That our share market has started the year strongly can be attributed to both our major resource companies and banks performing strongly.

The strength in Australian resource shares can be attributed to a significant rally in the iron ore price. This has arisen due to Vale, one of the world's 4 major iron ore exporters, suffering a dam collapse on 25th January in Brazil. This resulted in the tragic deaths of at least 150 people and will force Vale to reduce production by at least 40 million tonnes of iron ore this year. As a consequence, we are experiencing a global supply shock in iron ore, and the iron ore price has spiked from $75 US a tonne to over $90 a tonne in a matter of days. The share prices of our major resource companies have followed with Fortescue and RIO Tinto standing out. In the medium term, we are sceptical the iron ore price will continue to maintain pricing at these elevated levels. Given global iron ore production is approximately 2,000 million tonnes per annum, one could expect that within the foreseeable future this lost production will be made up from other sources around the world. In time, Vale will recommence production.

While starting from a very low base, our 'Big 4' Australian banks have performed well due to a favourable reception from the share market of the final Royal Commission report that was released after market on Monday 4th February. The following trading day, our major banks rallied between 4% (NAB) and 7.4% (WBC) over relief that there were no major structural changes recommended within the report. In reality, with the shaming the major Banks have incurred over the prior year, many of the proposed changes are already in the process of being implemented as the Banks endeavour to win back public trust.

Further, the Big 4 Banks appear set to have benefited greatly from one Royal Commission recommendation. That is, someone seeking the services of a Mortgage Broker should pay for those services directly and not allow the Mortgage Broker to be remunerated by the bank through which the subsequent loan was arranged through. This is on the basis that a Mortgage Broker, being paid by the bank, is effectively working for the Bank and not the customer and in doing so this creates a conflict of interest.

As detailed in an ARTICLE by Noel Whittaker, this is simply not going to happen. *'No young couple looking for a loan will be prepared to fork out over $2,000 to a mortgage broker to research the market and find out the best deal. Instead, they will go online to look for what appears to be the best deal and jump in.'*

Mortgage Brokers have been a key catalyst for increasing competition towards and between our major lending institutions and are now responsible for organising approximately 60% of all new housing loans. However, with the Mortgage Brokering revenue model set to be destroyed and business costs set to escalate dramatically as they conform to the additional requirement of requiring an Australian Financial Services License (AFSL), it is inevitable that, should these recommendations be implemented, there will be a mass exodus from the Mortgage Broking industry. If this occurs, our major Banks with their established branch networks, will regain pricing power. Ultimately, this will come at the expense of the consumer as interest rates trend higher as bank margins expand and additional costs such as establishment fees are 're-established'.

Given the Royal Commission was seeking to minimise customer exploitation, this is a perplexing recommendation and clearly one outcome of the Royal Commission that needs to be reviewed further. While the Liberal Government is willing to do so, Federal Labor has indicated they will not. In fact, Federal Labor announced they would adopt all recommendations of Royal Commission before they were even announced! That Federal Labor agrees to future policy decisions before they even know what they are is hardly a reassuring sign for our (in all probability) future Federal Government.

Should you be so motivated, you can access the Final Report of the Royal Commission HERE. To make the report more palatable, a summary of all 76 recommendations is contained in the first 42 pages.

In looking at how the Royal Commission impacts on a financial services business such as Horizon Investment Solutions (Horizon), we largely already operate in a manner that appears acceptable to Commissioner Hayne. In particular, operating on a fee for service basis, we do not receive trail commissions, which are set to be banned. The key change for our business appears to be recommendation 2.1. This stipulates that clients will need to 'opt in' annually and in advance to remain a client.

While this outcome in isolation is not a major imposition, it is just one of many burden's that have gradually been imposed on advisory businesses like Horizon over the years. I recently went through the rather sobering exercise of determining what Horizon as a business is now paying in compliance related costs for Graham and myself to continue to work as Financial Advisors. Excluding any allowance for time spent by Graham or myself to performing compliance related tasks (easily 25% of our work time) or associated office overheads, the dollar amount now exceeds $150,000 per annum!

Annual costs that contribute to this amount include Professional Indemnity insurance, industry specific audit expenses that confirm Horizon remains solvent, specialist compliance consultant fees, newly introduced ASIC fees for industry wide supervision, training and accreditation fees, AFSL management expenses as well as expenses associated with the generation of mandatory compliance documents. These costs continue to escalate and frankly offer next to no benefit to you as clients.

In addition to rising compliance costs, the industry is trying to grapple with new professional education requirements which are in the process of being introduced. In time it will be mandatory that these educational requirements are met for a Financial Advisor to continue to work in the industry. These include having a relevant post graduate degree (which Graham and I have), completing a wide ranging industry exam (notwithstanding many Advisors opt to specialise in one particular area) and completing a University standard Ethics course. While in isolation these recommendations may sound positive, the reality is that many Advisors, and in particular older Advisors that may have a lifetime of industry experience but not necessarily formal qualifications, will struggle to complete.

With compliance costs escalating, onerous professional standards being introduced and the business models for many Advisors being changed abruptly, I suspect the Financial Advice industry is about to contract rapidly. The Royal Commission will help expedite this process. While this could be perceived as a positive outcome for a compliant business like Horizon, the reality is that there are only so many clients an individual Advisor can assist.

This suggests that in the future, for the consumer seeking financial advice, if they can find an Advisor, the costs for obtaining advice are going to be dramatically higher. In terms of anecdotal evidence of rising costs, one client recently informed me that for his fellow co-workers seeking to obtain financial planning advice as they approached retirement, their superannuation provider was quoting Statement of Advice preparation fees of between $10,000 and $15,000. I find this a ludicrous amount and contrasts to our historical Statement of Advice Fees that we provided at zero cost and as a gesture of goodwill to help successfully establish a long term advisory relationship!

In saying the above, I stress that Horizon has no intention to change the fee structure of our business. Rather, to simply highlight the costs of regulation on financial advisory businesses and the flow on effect of increased costs to consumers seeking financial advice that do not already have an established relationship with an existing 'compliant' Advisor.

The Royal Commission was a complete success in terms of unearthing and highlighting unscrupulous conduct. However, in terms of outcome, given the resulting inadvertent support for the Big 4 banks, the tightening of credit currently underway, the reduction in alternatives available for the consumer in many areas of financial services as well as dramatically increased costs to obtain advice, it appears that Royal Commission may end up working against the consumer. To get to this point is a sadly ironic outcome!

I will try and be more upbeat next month!

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