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Whistleblowers, witch-hunts and wisdom

Dominic McCormick | Select Asset Management | 02 July 2015

In my 30 years in the investment and financial services industry, I've learnt some valuable lessons. One is that the greatest opportunities usually come from going in the opposite direction to the crowd – not blindly, but after assessing a situation objectively. Usually, this concerns asset allocation and investment opportunities, but sometimes you also see the industry rushing in a particular direction on other issues with little objective assessment or thought. Groupthink and feverishly following the prevailing trend are the key elements.

Most of us expect a financial services industry that does the right thing by clients. Companies and their employees, regulators and the media all have major responsibilities in achieving this. A perfect industry though, is unachievable in an area that carries the inherent uncertainty of investment markets and where many elements are far from black and white.

Adele Ferguson and Fairfax have done a good job to date of detailing the scandals and calling for reform of the financial planning industry, particularly around the activities of some of the banks. However, recent reports covering IOOF have, in my view, widely missed the mark and will do little to improve the industry.

More facts and objective assessment of the allegations raised are necessary. However, to me, this increasingly looks like a witch-hunt sparked by a bitter ex-employee(s) (the "whistle-blower") with curious access to confidential internal IOOF company documents, combined with the chase for a story by over-eager journalists who most likely don't fully understand those documents.

There is no doubt they have succeeded in generating a media frenzy and strong readership from an audience keen to devour more "evidence" that the financial services industry is corrupt. Even politicians have become involved with a speech in Parliament by Senator John Williams, as well as IOOF Managing Director Chris Kelaher and Head of Research Peter Hilton being requested to appear before a Senate enquiry next week.

The first alarm bell for me was the exaggeration in the headline on the first Fairfax article on 20 June 2015, entitled "IOOF's boiler room throws customers to the wolves". A boiler room is a fraudulent operation where fake or illiquid companies owned and promoted by the scammers are pushed to new investors with the insiders then dumping those shares to other new investors at the pumped-up prices. There is zero evidence that any such "boiler room" activity has occurred at IOOF.

I am all for getting crooks out of this industry. I was the "whistle-blower" who first alerted fund manager and blogger John Hempton of Bronte Capital to the Astarra/Trio fraud which cost investors around $200 million. I was also helping relatives of my partner get compensation from CBA for the poor advice of Don Nguyen long before Adele Ferguson was writing about it (albeit unaware of its scale at the time). In my view, "whistle-blower" actions in the financial services industry should primarily be about protecting current or prospective investors from losses caused by fraud or inappropriate advice, poorly structured products or leverage, or in helping them obtain compensation for such losses.

The Fairfax allegations in the case of IOOF (even if proven) are far removed from these situations. It is actually difficult to see how any of them would have resulted in money being lost by clients of IOOF. Of course, there have been some sizable losses for shareholders of IOOF in response to the media coverage.

I am not suggesting some valid issues have not been raised or improvements in processes and resources are not required, but it does seem that many of the allegations are historic and were dealt with at the time.

I suspect that if you had deep access to the internal documents of any significant financial services organisation in Australia and were pre-disposed to the negative slant on these, you would expose a lot of dirty laundry, particularly if you are willing to go back deep into history.

Before I go further, I should disclose I worked with Peter Hilton at Bridges from 1993 through to early 2001. I was not aware of any activities of the kind described by these allegations by Fairfax in the nine years I was there. I considered him a hard-working, passionate investment industry colleague who had a strong focus for doing the right thing by investors and advisers.

I was surprised at the level of responsibility Peter inherited over the last 10 to 15 years, as IOOF grew financial planner and client numbers through acquisition, particularly with only modest addition to research team resources. Running a research department looking after the needs of 1,200 advisers from different backgrounds with a small team is a mammoth task. No doubt the workload contributed to Peter's sometimes "short" manner that could occasionally put people offside. While my contact with Peter has been sporadic over those 10 to 15 years, invariably when it did occur it was because he wanted to discuss a suspect investment product that had come to his attention, or bad advice he had come across and was trying to remedy. He seemed to have investors' interests front of mind.

Further, I have no ulterior motives for defending IOOF. I hold no shares and IOOF's purchase of key financial planning businesses that were previous supporters of Select's funds led to significant redemptions in these funds. In addition, IOOF's Mosaic Portfolio Advisers pulled a $85m asset allocation mandate from Select in November last year just as a number of key positions (such as long China A Shares) began to work. But that's the swings and roundabouts of the investment management business.

I should also note that I hold some Fairfax shares, but am reconsidering that position. At least I won't be accused of front-running this article.

The source of all the allegations against IOOF is a mysterious (to those without Google) "whistle-blower" who worked in the company's research area. The whistle-blower has become a revered species since the GFC with their words often blindly accepted as "the truth". Most whistle-blowers are motivated to look after investor interests and to right a wrong. However, some are motivated by other factors such as monetary advantage, revenge or simply growing their reputation. It is vital to try and obtain some sense of a whistle-blower's motivations as these can greatly impact the validity and framing of the "wrongdoing" issues they raise.

Questions that need to be asked about the whistle-blowers in a situation like this include:

- Why does the whistle-blower have to remain anonymous?
- Why didn't s/he go to ASIC rather than the mainstream media?
- How did the whistle-blower legally get access to confidential internal company documents?
- How long was the whistle-blower with the company?
- How many of the allegations occurred while they were there and witnessed directly?
- Did the whistle-blower demand money from the company before leaving?
- Does the whistle-blower have a history of controversial departures at prior employment?

Unfortunately, the Fairfax media coverage does little to answer these questions. Cleary, not all whistle-blowers have integrity and some are masters of manipulating the media for their own purposes. I am reminded of Warren Buffet's words: "I look for three qualities in hiring people, integrity, intelligence and energy. And if you don't have the first then the last two will kill you".

I will not comment on all the various allegations (potential front running of reports, float allocations, etc) as I don't believe readers have sufficient facts to do so. The insider trading issue relates to a previous employee who has long since departed the company.

However, let's be clear what we are talking about here in regard to the Kaplan training issue. Kaplan is yearly compliance training that involves a series of modules with four multiple choice questions. Its value in either adding to one's ability to do the job or in testing competence to do it is questionable. Of course, having another staff member do your annual training is clearly wrong, no matter how stretched for time you are, and should result in some internal disciplinary actions. But does it warrant sacking or alerting ASIC or a Royal

Commission? Clearly, it is an internal compliance matter, not systemic cheating as Senator Williams' statement suggested.

The weakness of the Fairfax arguments were highlighted last weekend (27 June) when two full pages were devoted to criticising Bridges' policy of re-branding external research reports - a common industry practice - and placing a different recommendation compared to the source report, implying there could never be any valid basis for this. But couldn't a different internal macro view - for example, a view on the direction of interest rates, employment or other risks - justify a different recommendation?

Integrity and professionalism is not something that can be easily manufactured or defined by a compliance plan or a Kaplan training module. It is something much more integral to the individual and how they deal with clients and colleagues and how this builds overall to a good corporate and industry culture. Good leadership is crucial.

Investment research and management is a demanding occupation in an uncertain area where mistakes are inevitable. Even the best researchers or investment professionals have made investment decisions they regret and can be heavily criticised for in hindsight. Further, under the day-to-day pressure of dealing with volatile markets and adviser and client demands, occasional lapses in normal process are not unexpected. In this context, perhaps all senior participants in the investment industry are just one disgruntled colleague and one rabid journalist away from disgrace. Perhaps that's why the salaries are high.

Some of the articles also focus on administrative issues such as mistakes in performance reports and unit price errors. The reality is all fund managers and financial services businesses which have been in business for any length of time will occasionally make such mistakes. Of course, this is an area where quality people and processes are crucial.

Perhaps Fairfax is running out of easy targets in what seems like an ongoing campaign to support the dubious and expensive case for a Royal Commission. However, this campaign reminds me of a long running successful TV soap or mini-series on its last legs. The early shows are excellent - well scripted and professionally acted - but, as time goes on, the scripts and actors become lazy, the plots become more unbelievable and there is a need to sensationalise events to keep people engaged.

It would be great if the media focused instead on real crooks who are actually trying to steal clients' money or put them into totally inappropriate investments. Of course, this requires foresight and the risks of being wrong rather than only digging into and sensationalising history. Today, the range of industry participants taking high fees from clients for squeezing overpriced residential properties into SMSFs could be a good starting point.

I am not denying that the industry still has a long way to go to improve and gain the confidence of investors. This challenge is compounded by what is likely to be a much tougher investment environment given elevated valuations across most asset classes, record low interest rates, high debt levels and a range of global macro risks. Given this, we cannot afford key players in the industry to freeze up and be constantly distracted by excessive compliance or regulatory burdens implemented in reaction to hyped up situations like IOOF.

There is also a risk that this environment encourages the departure from the industry of experienced professionals with integrity but who are frustrated by excessive red tape and inability to focus attention on the most important issues for clients. The experience and wisdom of such people is sorely needed, both to help investors navigate a more challenging investment environment and because they are more likely the ones who can spot the frauds, dangerous products or inappropriate advice that can result in permanent losses for clients.

Whether the allegations stand up or not, Peter Hilton's career and reputation has already been destroyed, as has the broader reputation of IOOF. Markets will likely forget the latter but not the former. All this without any role by regulators or fair assessment of the full facts - and, so far, without any real chance to defend their position. And how many clients are better off for this?

The media, politicians and a range of industry participants who have joined and helped propel this witch-hunt need to stop and think. Is this right? Is this fair? And, is this the best way to build a better industry and win back confidence of investors? In the fog ahead we can faintly make out the sign - WRONG WAY, GO BACK!

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