AURORA FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

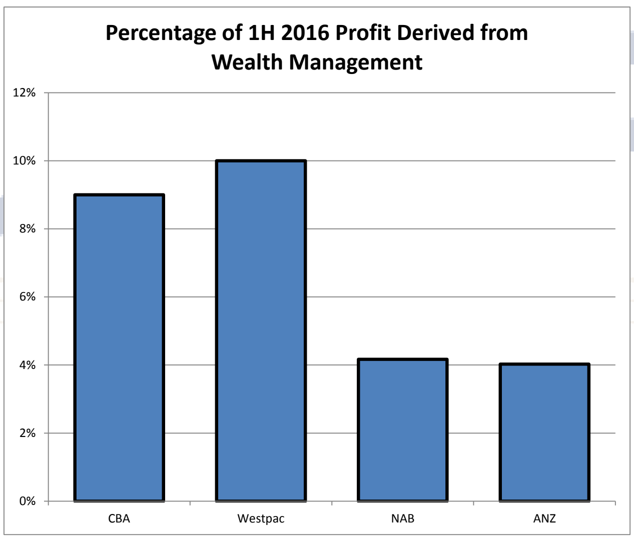
By Hugh Dive 13th May 2016

Funds Management in Australia

The business of funds management, and in particular the debate over vertical integration of advice, administration and management, has gone quiet after Labor's Future of Financial Advice (FOFA) was ushered out in March 2016[1]. After a week I have spent poring over bank results and seeing how involved they are in the business of managing Australia's investments, this week we are going to have a closer look at the funds management landscape in Australia, and in particular the dominance by the largest players of this A$2.6 trillion industry.

Influence of the Major Institutions

The wealth management businesses of the major banks (plus AMP) include funds management, life insurance and general insurance, investment administration platforms and financial advice. The wealth management business is attractive for the banks, not only due to the government mandated growth that comes from rising compulsory superannuation contributions, but also because wealth management earnings carry a low capital charge. This attraction has only increased with the $19 billion of capital raised in 2015 to meet Australian Prudential Regulation Authority's (APRA) tougher stance on bank capital adequacy.



Whilst this is not the most exciting of topics; changes to capital requirements both make funds management earnings more attractive to the banks and increase the cost of lending to business and home loans. When a bank makes a standard home loan with a 70% loan to value ratio (LVR), the Australian Prudential Regulation Authority (APRA) requires that the bank holds approximately $2.25 in capital for every $100 lent. This rises to $5 for every $100 in the case of a loan to a business that incurs a higher risk weighting. Mathematically, when a bank is required to quarantine more capital to conduct activities; their return on equity (ROE) declines. This may not seem very significant, but in an environment where the Australian banks are facing higher capital requirements from regulators globally; earnings from wealth management are very attractive as they can boost the bank's return on equity.

Profitability

In the 2015 financial year, the four major trading banks in aggregate earned $30 billion, representing an increase of 5% on 2014. A significant proportion of this came from the banks' wealth management operations totaling $2.7 billion. In 2015 approximately 10% of the bank profits were attributable to their wealth management divisions, with CBA (Colonial First State) and Westpac (BT) gaining a higher percentage of profits from wealth than the Melbourne-based banks. In the Aurora Dividend Income Fund we have our exposure to wealth management indirectly via positions in the banks, rather than in listed wealth

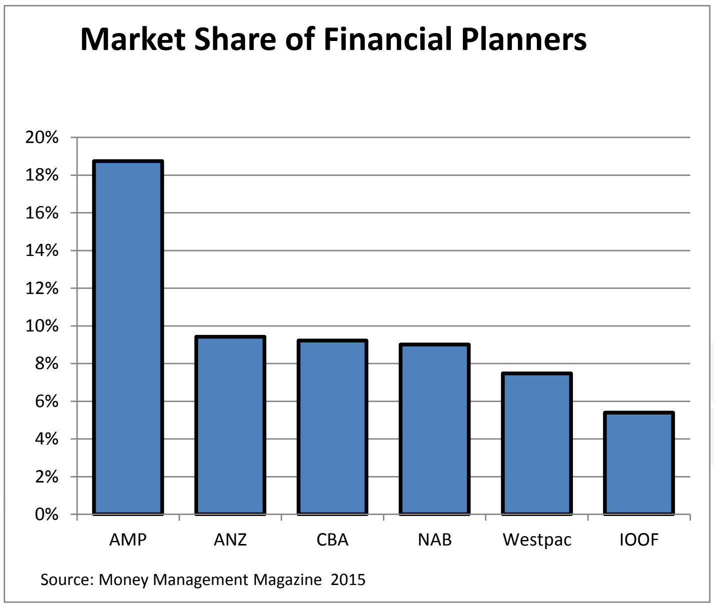
[1] *Corporations Amendment (Financial Advice Measures) Bill 2016*

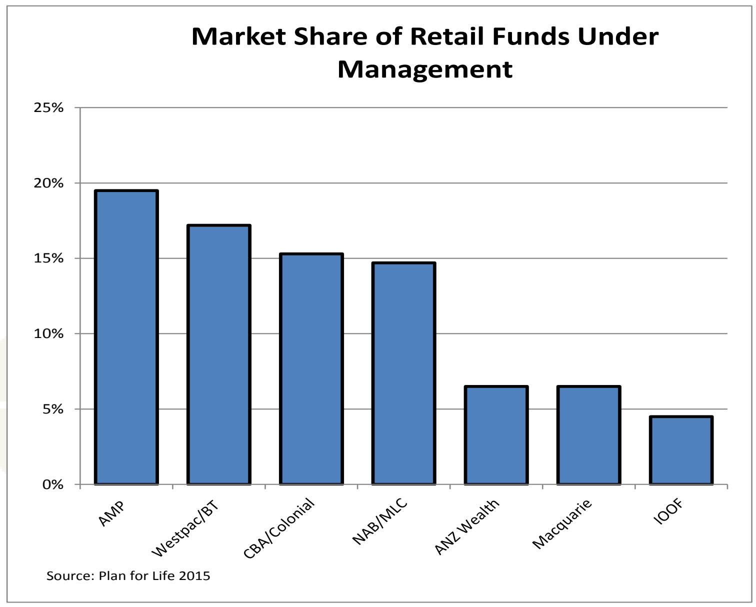
managers such as Perpetual or AMP. This results in buying $1 of wealth management earnings on a price to earnings (PE) of 13 times rather than 16 times!

Vertical Integration – Clipping the Ticket at three Stages

Essentially the wealth management industry comprises a value chain of advice (financial advisers), portfolio administration (platforms) and manufacturing (funds management). The major financial institutions have captured a dominant market share in these three links in the wealth management chain via acquisitions and IT expenditure. From the below chart on the right, the four major banks plus AMP and IOOF have financial relationships with 60% of the financial planners in Australia. Their market share has been increasing with acquisitions (Count acquired by CBA for example) and heightened compliance requirements tend to favour the large institutions over smaller practices.

Investment platforms are the "middle man" in the process, connecting the fund manager to the adviser providing administration services and tax reporting for a client's portfolio of managed funds, shares and cash. Platforms generally charge around 0.3-0.6% of funds under management annually. Whilst this may not sound very glamorous, this has been a lucrative area for the major financial institutions, which by virtue of their IT expenditure have been able to capture over 85% of this market.





Finally the major financial institutions have also been very successful in capturing a large share in the business of actually managing the money. The above chart on the right demonstrates the dominance that the large institutions enjoy in "manufacturing" the investment products or funds for sale to retail investors. Currently the major banks plus AMP manage almost 80% of the retail funds under management.

Negatives

Whilst this sounds like a solid way for banks to supplement banking profits in an environment of relatively anemic credit growth and rising bad debts, the ownership of wealth management businesses by the banks do pose some risks.

Aside from the volatility in investment returns, wealth management businesses have the potential to deliver adverse headlines that could impact on an institution's core banking business. Over the last year CBA and Macquarie Bank have received "enforceable undertakings" from ASIC and face political enquiries related to allegedly fraudulent behavior and bad financial advice from the banks financial planners.

Indeed in 2015 CBA spent $522 million in advertising building its banking brands. One would have to imagine that a portion of the goodwill that spend generates is dissipated by headlines detailing ASIC probes into the bank's financial planning or insurance divisions. The banks are clearly concerned that negative activities occurring in the wealth management businesses do not spill over to damage their core banking brands that generate the bulk of their profits.

Our Take

The major financial players have not built these vertically integrated wealth platforms (advice, investment accounting and funds management) to see large amounts of value being "leaked" to service providers outside the network. This naturally creates strong incentives to recommend the house products over independent providers, or favour house products over external products with similar or even slightly superior characteristics. As an investor in the major banks, we would prefer

that they keep as much of the value in-house to boost payments to shareholders, however as the fund manager of an independent boutique investment firm I obviously have a strong personal incentive to see funds being leaked out of the control of the major players.

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- **Aurora Dividend Income Trust (Managed Fund) (ASX code: AOD)**
- **Aurora Absolute Return Fund (ASX code: ABW)**
- **Aurora Fortitude Absolute Return Fund**
- **Aurora Global Income Trust (ASX code: AIB)**
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