ASX fund choices

Dominic McCormick | Select Asset Management | 11 February 2015

The recent listing of the Magellan Global Fund (ASX Code MGE) has essentially introduced a new structure into the universe of ASX listed and quoted funds. There is now an array of fund structures offered on the ASX trading and/or Chess settlement system across asset classes. These can be divided into the following:

1. Listed Investment Companies (LICs) – typically actively managed funds in a closed end (mostly company) structure. There are currently around 65 of these with a combined market capitalisation of over A$27 billion.

2. Exchange Traded Funds (ETFs) – currently, there are over 100 Exchange Traded Products (mainly passive) with a combined market capitalisation of A$17 billion.

3. mFund – a range of 40 unlisted funds (typically active) funds available through some brokers and the Chess system but without live pricing/transactions.

4. Exchange Quoted Managed Funds (EQMFs) – these also trade intraday on the ASX, with MGE arguably being the first, but unlikely to be the last.

Listed property and infrastructure funds, which are a long established and prominent component of the local market, could also be included. There are 48 A-REITs with a combined market cap of A$120 billion and nine infrastructure vehicles with a combined market cap of A$53 billion.

The greater choice of funds available via the ASX is a welcome development for investors. However, it also creates some confusion as to the relative advantages and disadvantages of each structure and how they should be used in portfolios. It also provides challenges for various industry participants, from advisers, to researchers, to platforms, as the ASX moves closer to being able to offer all the components to build a well-diversified portfolio. This is particularly important for Self Managed Super Fund (SMSF) investors who have become very comfortable with the ASX platform. Increasingly, investors can move away from the concentrated home bias and lack of asset diversity of a conventional ASX-focused share portfolio while still using only ASX offered vehicles.

LICs are the oldest, and in some respects, the most complex of the listed fund structures. This reflects their company structure and closed end nature, which means that the market price can vary substantially from the underlying net asset value (NAV). Of course, this fluctuation creates both opportunities as well as risks for investors.

However, the three other structures are aiming to ensure that investors enter and exit at close to NAV. This will always be the case via mFund and unlisted funds generally (other than small buy/sell spreads) and it will usually be the case for ETFs and the new EQMFs. However, both of these latter two structures rely on market makers prepared to buy and sell and create and redeem units to ensure that trading is close to NAV. At times of extreme market volatility, bid/offer spreads may widen markedly (at such periods, investors who need to sell or buy may be doing so well below or above NAV). While such periods are likely to be the exception rather than the norm, the fact that wide spreads and "gapping risk" will likely occur at times when markets (and investors) are most stressed should not be dismissed lightly.

The new Magellan EQMF differs from ETFs in that the gains or losses from market making accrue to the fund, not to one or more eternal parties. In addition, unlike ETFs which typically report their full portfolios daily, EQMFs will only be required to report their portfolios quarterly and even then with a considerable lag, thereby protecting the manager's intellectual property. The new structure is certainly innovative and potentially a game changer for some funds. A very liquid listed active managed fund vehicle which investors can trade intraday, knowing that pricing will generally be close to NAV, is clearly appealing for many investors. The fact that, as a new fund, it does not have the inbuilt tax liabilities of the existing Magellan Global Fund is a not insignificant advantage also.

I understand there have been significant enquiries to the ASX from fund managers since Magellan announced and launched the new fund. However, I believe that, in practice, the structure really only makes sense for funds focused on large cap, very liquid securities and for those managers which already have, or which are committed to building, retail brand recognition. Still, there are a number of managers with these attributed which could do extremely well out of this structure.

My main reservation over EQMFs is related to the possibility of markets entering a period of major volatility in the early days of this structure's emergence. Extreme day-to-day and intraday volatility would almost certainly see much wider spreads, the possibility of the fund making losses from its market making activity (with resultant underperformance of the equivalent unlisted fund) and, thereby, a loss of confidence in the structure. I see this as a low risk but not one to be totally ruled out.

We could see a world develop where established brand name, large cap, active local and global managers seeking retail investors do so via the EQMF structure. Boutiques and less well known fund managers and/or those focusing on less liquid securities and esoteric asset classes (but still keen to have an offering through the ASX platform) will launch either a LIC or offer a fund through mFund. ETFs will continue to grow with more enhanced passive and smart beta offerings blurring the lines between active and passive management.

But what does this growth in ASX fund options mean for investors, advisers, researchers and platforms?

© PortfolioConstruction Forum 2015

Investors can now build robust, diversified portfolios of both active and passive fund using only ASX-listed or quoted funds, something that wasn't possible even just a couple of years ago. There are certainly still implementation issues - spreads are still too high on some ETFs, and LICs are often illiquid and the divergence from NAVs creates challenges, while the number of fixed interest and alternative offerings is still rather sparse.

The increasing range of vehicles is providing the building blocks for more active and dynamic portfolio construction approaches as well as longer term buy and hold portfolios. ETFs are an ideal vehicle for dynamic asset allocation and the retail dominated LICs often provide market inefficiencies that can be exploited by nimble investors. Even ETFs occasionally provide such opportunities. Of course, the discipline and flexibility needed to exploit these more trading oriented opportunities is not the main focus of most investors or advisers.

While a few specialist funds attempt to take advantage of these opportunities, a key aim for most investors and advisers should be to avoid being on the wrong side of these inefficiencies/opportunities. Amongst other things they should therefore at least avoid:

- placing market orders or hitting the bid/offer irrespective of the spread size or current/estimated NAV on listed fund;
- chasing a hot ETF simply because it has performed well lately;
- paying large premiums to NAVs on LICs; and,
- selling out of funds simply because recent returns have been poor without understanding why.

An example of how choice of vehicle can be so important is the recent relative performance of the listed Platinum Capital, a LIC (ASX Code PMC) and the unlisted Platinum International fund. If an investor bought PMC on 8 August 2014 at the closing price of A$1.945, they would also have since received dividends of 10 cents. Given the closing price of PMC on 10 March 2015 of A$1.71 and excluding tax effects (as the dividends were fully franked), the total return for the seven month period was -7%. Meanwhile, over exactly the same period, investors in the unit trust (with essentially the same underlying portfolio) would have received a positive return of almost 17% - highlighting the risks of paying a large premium to NAV in a LIC.

Greater choice is generally a good thing for consumers. However, in the complex world of investing, greater choice increases the risks of poor decisions and misunderstandings that can reduce investors' and advisers' commitment to a robust investment approach.

For researchers, the growth of fund structures raises new questions about how each should be assessed, particularly when they are holding the same assets. For example, how do researchers incorporate elements such as the ability to trade intraday into an assessment of a product's benefits? How do they (or suggest that advisers) deal with various levels of

© PortfolioConstruction Forum 2015

discounts or premiums to NTA on LICs given the significant impact this can have on future return and risk as shown above? How is the relative tax positioning and effectiveness of different vehicles assessed?

For traditional administration platforms there are growing challenges if investors demand, and advisers are forced to build portfolios only with ASX-listed products, particularly as stand-alone tax reporting and administration around these improve. Extremely low interest rates and minimal prospective returns on a range of fixed interest/defensive investment options are also leading many to question the benefits of investing through a platform.

Clearly, the ASX is trying to build a financial supermarket. But as its shelves fill up with an array of products, shoppers (investors and advisers) will need good information and research to fill their baskets efficiently.

Some traditional platforms might start to look like the corner shop, perhaps with more personalised service but with higher prices, poorer transparency and declining customer loyalty as investors (and advisers) increasingly head to the increasing range of lower cost direct options at the ASX.

Dominic McCormick is Chief Investment Officer and Executive Director of Select Asset Management. Dominic has worked in investment management and financial services for 27 years and co-founded Select Asset Management in 2002. He has overall responsibility for investment strategy and research for Select's range of multi-asset, multi-manager portfolios, investing across the spectrum of traditional and alternative investments

---

© PortfolioConstruction Forum 2015