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Magellan's "monster" listed trust - masterstroke or misfire?

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The Magellan exchange traded managed funds (ETMFs), were a significant innovation for investors when launched in early 2015. At the time, I highlighted that it made sense for other large brand name equity managers to follow – and several others have launched funds, including Platinum launching two listed feeder funds this month.

Meanwhile, Magellan is innovating again, this time raising money for what's been called a "monster" closed end listed investment trust (LIT) with features that dramatically raise the bar for the standard model of closed end listed investment vehicles of recent years (i.e. Listed Investment Companies (LICs) with high initial and ongoing costs and "free" attached options).

Barring a major sell-off in global markets in the next month (certainly a possibility), I expect the new Magellan Global Trust (ASX code MGG) to be a roaring success from a fund raising perspective. It will likely still be a solid fund raising success with such a sell-off. Targeting a minimum $250 million (with no maximum), it should raise multiples of that, perhaps several billion dollars.

Given the Priority Offer of Loyalty Units (discussed below), it certainly looks attractive to existing Magellan investors and shareholders, especially with Magellan Financial Group (MFG) also covering the initial costs of the offer.

However, as with most listed vehicle IPOs, there is a short timetable and the ability for investment advisory groups and their platforms to move quickly will also be a factor in the offer's success. A 1% stamping fee paid by MFG to AFSL holders will help. The offer opened on 29 August and will close in late September with listing expected on 18 October 2017.

It is less attractive for non-Magellan investors to participate in the Broker Firm or General Public Offer, given the absence of the Priority Offer Loyalty Units and the range of Magellan vehicles already available in listed or unlisted form. However, the Magellan brand, the payment of the initial costs, trading opportunities around the Loyalty Offer, and the number of major brokers involved keen to earn a selling fee of 1.5% (joint lead brokers receive an additional 1%) suggest the Broker Firm component will also be very successful.

As an investor in listed investment funds, particularly when available at interesting discounts to Net Asset Value (NAV), I welcome the addition of a large, liquid, vehicle to that potential universe. I also welcome the pressure that this innovative fund will bring in encouraging the industry to provide more investor-friendly terms in future listed investment vehicles.

However, as discussed further below, behavioural responses to the incentives in the structure may result in future trading dynamics and more complex investment outcomes than the structure of the offer implies. For some, the offer may prove not quite as good as it first appears.

GLOBAL EQUITIES NOW?

One can also question whether now is a great time to be adding to global equity exposures given expensive valuations (especially in the key US market), growing geopolitical risks, and a dangerous complacency marked by low recent market volatility and the (for now) supportive flows of passive and other "non valuation-based" investors.

However, Magellan's caution over recent years, which has led it to hold around 10% to 15% cash in its global portfolios, seems to have lessened recently. In *The Australian* on 9 August, Hamish Douglass was quoted as saying that, in the absence of war in the Korean Peninsula, he couldn't see a triggering event for a pullback in markets and that "the world's financial system is in better shape than it's been in decades". The same article did highlight the attractions of overseas currency exposure with the Australian dollar looking somewhat expensive at around 80 US cents.

THE STRUCTURE

The Magellan LIT portfolio mandate differs from Magellan's standard global offering with a more concentrated 15 to 35 stocks, broader asset ranges with up to 50% cash and 20% gross leverage (mainly for buybacks), and with currency actively managed rather than set as hedged or unhedged. It has the same (higher end) fees as Magellan's other global trusts, with combined management and administration fee of 1.35% per annum and a half-yearly performance fee of 10% over the higher of the MSCI (AUD) index or the 10-year Australian Government Bond yield. The portfolio will be co-managed by Hamish Douglass and Stefan Marcionetti.

MFG will directly cover the costs of the Offer, effectively keeping the initial $1.50 NAV intact on day one, a significant saving for investors who typically lose between 2% to 4% of NAV to LIC IPO costs. Other new funds are also addressing these up-front costs in positive but less direct ways, such as management fee deferrals (proposed LIC VGI Partners Global Investments Limited, ASX code VG1) or simply capitalising the costs and then writing them off over a number of years (Proposed LIT MCP Master Income Trust, ASX Code MXT). It is also worth noting that Magellan, as the trust's Responsible Entity, will also cover the cost of certain ongoing expenses including custody, ongoing ASX listing costs, and unit registry which would normally be borne by investors.

As with the two other new offerings mentioned above, there is no attached "free" option. MFG seems to believe, as I do, that these options in many recent LIC floats are somewhat of a gimmick that confuse investors and weigh on secondary market demand given potential dilution.

THE POWER OF INCENTIVES

The most controversial and appealing aspect of the Magellan LIT offer is the Priority Offer to Magellan unitholders and shareholders as at 1 August. This provides a 6.25% bonus in additional "Loyalty Units" to direct and indirect unitholders and shareholders for investments up to $30,000 or on 10% of their current Magellan investment (whichever is higher). That's $1,875 worth of "free units" for a Magellan unitholder or shareholder putting $30,000 (20,000 units) in MGG. To receive the Loyalty Unit entitlement, investors have to retain their investment in MGG until 11 December 2017, with the new units expected to be issued on 15 January 2018. (Note, no Loyalty Units apply to the proposed $20 million investment by Hamish Douglass which will be through the General Offer).

This innovative but generous structure has raised the possibility that the incentives being offered will be gamed and distort the behaviour of investors and other participants in the process. It should also be noted that the 6.25% "bonus" for current Magellan holders, while real and very generous, is not something investors can take off the table with certainty given the loyalty period (albeit short, at less than two months from listing), underlying NAV movements, as well as the ongoing pricing of MGG relative to that NAV.

Given the MFG founders are keen followers of Warren Buffett and partner Charlie Munger, I wonder whether Munger's many insightful comments on the power of incentives - such as the following - have been fully considered:

> "I think I've been in the top 5% of my age cohort all my life in understanding the power of incentives, and all my life I've underestimated it. And never a year passes but I get some surprise that pushes my limit a little farther."

So where could the incentives in this offer create issues/distortions?

1. Magellan unitholders may be encouraged to sell some of their existing investments to finance an investment in MGG to receive the 6.25% bonus, effectively cannibalising existing Magellan funds under management.
2. The Loyalty Unit structure may limit any early selling pressure and help ensure a small short-term premium to NAV which could be exploited by some shorter-term investors in the General or Broker Offer (albeit obviously not without risk given market/NAV movements).

3. Due the 6.25% bonus units, Priority Offer investors could be tempted to sell on market after the Loyalty Unit vesting and issue dates (11 December and 15 January, respectively), even down to a discount to NAV while still being able to make a small profit (assuming no major move in the NAV in the meantime).

The possibility is therefore that the MGG unit register will be dominated by those driven by near term incentives and a short-term outlook but who may not fully appreciate the ongoing pricing dynamics of a listed closed-end fund impacted by these incentives. To the extent this is the case, one may end up with a relatively small base of investors buying in with a true long-term outlook suited to this asset class and strategy.

If the incentives discussed above (and below) are as effective as I expect, the net costs to MFG may be greater than expected (albeit partially offset by an even larger starting vehicle).

Indeed, the generous terms of the Offer seem to have made some analysts and shareholders of MFG a little nervous, with the share price falling since 10 August when annual earnings and the MGG launch were announced. Costs of the Offer and the Loyalty Units are to be booked as a one-off expense in the current financial year and have been estimated at between $50 million to $100 million. It is possible to come up with higher estimates.

CHASE FOR YIELD

It is interesting that MFG chose the LIT structure for MGG after reportedly first considering a LIC. The unit trust structure can be more transparent and potentially more tax efficient compared to a LIC (many of which do not participate in the capital gains tax discount). However, the trust structure does have the challenge that all income including realised capital gains generally has to be distributed, which can lead a fund to stagnate in size or shrink over time.

This has been addressed by offering a Distribution Reinvestment Plan (DRP) and by MFG being willing to pay for the DRP's 5% discount to NAV to make it attractive and prevent any dilution to non-participating DRP holders.

Magellan is making a big deal of the Target Cash Distribution yield of 4%. The plan in the first two years is to pay three cents each half year (starting December) and after that, set a 4% annualised yield based on rolling 24-month NAV, announced six months in advance.

A current challenge is that the dividend yield on the MSCI ex-Australia is running around 2.4% and after 1.35% per annum in costs, that's around 1%. You could add a little by skewing toward higher yielding stocks but the MGG portfolio is unlikely to be significantly higher. This indicates the 4% distribution "yield" can only be achieved by supplementing underlying dividends with significant realised capital gains (or paying back unitholder capital). Of course, these realised gains are uncertain and any realised losses will also offset this and may necessitate capital repayments to meet the yield target.

If MGG pays a distribution higher than the 4% per annum yield, Magellan can require that all investors automatically re-invest this excess distribution with no discount to NAV (in contrast to the 5% discount on the normal DRP which is paid for by MFG).

While MFG's willingness to finance the discount to NAV up to the 4% yield is generous, I again question whether the incentives and all the scenarios have been fully considered.

What if there is much greater participation in the DRP than expected (and higher costs to MFG) as even yield hungry investors find other sources of income or periodically sell off units to finance their cash flow?

What if the fund's units trade at a larger than 5% discount to NAV? Clearly, the DRP at a 5% discount to NAV would not be attractive to investors if the fund was trading at a 10% discount. If MGG pays a distribution above the 4% yield and all investors are forced to reinvest this excess at NAV, there is even greater chance that this reinvestment could be at a price above the current MGG market price, a potential recipe for broad investor dissatisfaction.

Could the level of DRP participation vary wildly depending on where the MGG unit price is in relation to NAV?

Will MGG buy back units on market to cover DRP units if the level of the discount to NAV makes it more effective to do so (this may inhibit growth in the size of the vehicle)?

It should also be noted that Magellan can change the level of the Target Cash Distribution or terms of the DRP at any time.

SCALE AND DISCOUNTS

MFG is clearly keen to achieve significant scale for MGG. Hamish Douglass stated on the 10 August 10 results call that he believed a minimum $1 billion was necessary for that scale. He also said he saw the fund as "semi-permanent" capital, clearly understanding that there is really is no such thing as "permanent" capital in the listed fund space (as the managers of some closed-end funds targeted by activists have discovered). Still, some may see the cost of acquiring this "semi-permanent" capital as unreasonably high, particularly if MGG is forced, by a large and/or persistent discount to NAV, to undertake substantial buybacks that may reduce the fund's size over time.

Magellan seems confident that MGG will not trade at any significant discount. However, when Hamish Douglass and Chris MacKay launched the Magellan business back in 2006 by first launching a LIC (Magellan Flagship Fund now MFF Investments, run by Mackay), I was sceptical that this was a sensible approach given the possibility of MFF trading at significant discount to NAV at some point and the reputation damage this could cause. I even had a vigorous phone call with Hamish Douglass about the issue in late 2006. He assured me that the vehicle was unlikely to trade at any significant discount. (I received a similar response from Pershing Squares Holding's Bill Ackman in a Sydney boardroom before that vehicle listed on Euronext in 2014. This $US4 billion fund now trades at a 20% plus discount to NAV and is currently a small position in a fund I oversee).

In the end, on MFF, I was both right and wrong – right in that MFF did trade down to a major discount to NAV around the GFC (I was buying shares at up to a 35% discount in early 2009) but wrong in that this situation, while a little embarrassing for a time, did little to inhibit MFG's broader business growth as the unlisted business took off, especially with good performance through the GFC.

ONE VIEW

At the risk of being wrong again, here are my predictions/guesses regarding the MGG float and its broader implications:

1. MGG will be a huge success in raising money barring a major "risk off" event for markets through September (and even then, would still be a reasonable success). Many existing Magellan unit holders and shareholders will beg, borrow and (maybe) steal to invest for the 6.25% Loyalty Units, encouraged by their investment advisers. The Broker firm and General Offer will also likely be very successful.
2. However, some of these new funds will come from existing Magellan products while some will come from redemptions from competitor fund managers. While negative for these fund managers, this could be a sensible approach for rationally cautious investors unwilling to increase overall equity exposure in the current environment.
3. Some new funds will also come from the on-market sale and likely de-rating of existing LICs, suggesting premiums to NAV will shrink or discounts grow on such vehicles (some of which I believe is already occurring). This will potentially provide some attractive investment opportunities with this de-rating likely to be focused on, but not restricted to, global LICs.
4. The incentives in the structure could result in MGG trading at a small premium to NAV until the vesting/loyalty period is past and the extra units issued in December/January. There is also likely to be lower than average liquidity relative to the fund size until this occurs (although this will also partly depend on the relative mix of the Priority compared to the Broker/General offer).
5. After the loyalty unit vesting period, I would expect MGG to trade down to a small discount, with the result that some Priority Offer investors may be disappointed they cannot realise most or all of the 6.25% bonus from a total value perspective. The size of this discount to NAV will also partly depend on overall market sentiment and the initial NAV performance up to that time.

6. As we move well beyond the loyalty vesting period, it will be difficult for MGG to ever trade at any significant or sustainable premium to NAV, given some ongoing selling pressure from Priority Offer unitholders, gradually increasing selling from Broker/General Offer holders, and the availability of near equivalent, listed and unlisted Magellan funds trading at NAV.
7. While brokers will likely be very supportive at the IPO stage given a dearth of commission opportunities, the ongoing loyalty of most to Magellan and MGG is questionable. Eventually, perhaps in a period of poor performance or simply because the investor or broker gets bored and sees MGG as a source of cash for new ideas, they will increase selling pressure, resulting in a growing discount to NAV and feeding some investor dissatisfaction.
8. The longer term performance and pricing relative to NAV of MGG will therefore partly reflect investment performance and the market environment generally. Given current global valuations, geopolitical and policy risk, and excessive complacency, the downside risks are not insignificant.

In a major "risk off" environment, a combination of poor NAV returns and a discount to NAV of around 20% is certainly possible, a result which could see very poor outcomes for investors, at least for a period (although I doubt we will see the 35% discounts of MFF post-GFC, given the greater brand presence of Magellan now compared to 2009 and size of MGG). While MFG suggests buybacks would prevent MGG ever trading at a 20% discount, we know that these are not always effective or there is sometimes not the commitment to do them in the size that would be effective in narrowing the discount (although even then such buybacks are accretive to NAV for remaining investors).

In more benign times, beyond the loyalty unit vesting/issue dates, my best guess is MGG will normally trade at a variable, single digit discount.

9. MGG clearly has far more going for it than most listed investment fund floats and will set some precedents for the characteristics of listed funds offered in the market going forward. Investors will expect initial (and more ongoing) costs to be at least partially funded by the manager and the "free" option structure is likely to become less common or even disappear. An increasing number of LITs rather than LICs are also likely, especially for income-focused strategies.
10. For MGG itself, the initial benefits of the Loyalty Units and payment of costs will largely be forgotten over time and it will be the medium- to long-term investment performance and ongoing trading dynamics that determine investor returns and experience.
11. The MGG offer on this scale (and current success of the VG1 and MXT offers) is, somewhat ironically, an acceleration of both the trend by fund managers to bypass investment advisers and diversify their client base, and the trend amongst investment

advisers to build portfolios using listed rather than unlisted investments. It is notable that the approval process at many dealer groups and platforms is often easier for listed funds (notwithstanding the challenge of short timetables at the IPO stage).

CONCLUSION

Therefore, while a successful fund raising seems assured, it will take time and history to judge if MGG really is a true and long-term "game changer" in the listed fund space. However, the willingness to recognise the limitations of current listed fund structures and attempt to directly address them is to be applauded and highlights the beneficial role of fund managers with strong leadership, a longer term perspective, and the ability to take significant risks with their balance sheet.

On the other hand, there is a possibility that MGG's "monster" trust is seen as another harbinger of the "top" of the current global equity boom (perhaps along with Magellan's Cricket Australia sponsorship). It may also become seen as commercial overstretch where MFG showed excessive faith in the long-term loyalty of its clients and supporters.

In any case, history will have a view on what is likely to be the largest fund IPO in Australian history to date - which is more than you can say about many of the investment products launched in recent decades. Masterstroke or misfire, investors and the financial services industry would benefit from more fund managers showing the same initiative and courage to introduce innovative vehicles that significantly lift the bar for those that follow.

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