Brent Sheather's
RESEARCH
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FUND MANAGEMENT – MOVING THE PERFORMANCE GOALPOSTS – Part 2

Two weeks ago, in the first part of this story on managed funds' performance, we reviewed a paper by two PhDs at the Universities of Florida and Arizona. Their research highlighted the fact that good relative performance is critical to increasing funds under management and thus profits. Their paper, entitled "Moving The Goalposts? Mutual Fund Benchmark Changes and Performance Manipulation", showed that fund managers exploit the law in the USA that allows them to change the benchmark against which their performance is assessed so as to "look good". Recall the cynical comment in the London Financial Times of a few years back: "the best way to look tall is to stand by a short person".

Today we will look at a local example of a managed fund which has altered its benchmark about 10 times in the 16 years that it has been going. We also get some perspective from the FMA as to whether they see the performance manipulation problem highlighted in the report as being an issue in NZ, given their "statutory duty is to promote and facilitate the development of fair, efficient and transparent financial markets: and to promote the confident and informed participation of businesses, investors, and consumers in the financial markets". Lastly we compare how performance relative to the benchmark is actually "disclosed" to investors in NZ versus the USA and conclude that Ministry of Business, Innovation and Employment (MBIE) could have done a much better job and saved taxpayers a lot of money by just replicating the US Securities and Exchange Commission's (SEC) approach.

First off we take a look at a local managed fund investing principally in global equities which has been operating for about 16 years and in that time has changed its benchmark about 10 times. After reading the "Moving the Goalposts" paper and seeing that many changes to its benchmark I decided to look at its post fees, pre-tax performance relative to the benchmark that it initially started life using i.e. the world stockmarket in NZ$ terms. After some work the results are summarised below:

	Return since inception (post fees, pre-tax, %pa)	Value of an initial investment of $1,000
Global Equity Fund[1]	6.6%	$2,825
World Stockmarket[2]	7.4%	$3,190
Global Equity Fund's Benchmark[1]	6.7%	$2,860

[1]Source: Fund Manager, PAM
[2]Source: Refinitiv

So, as per the table, since inception the fund returned 6.6%pa, versus 7.4% for the original benchmark and 6.7%pa for the benchmark subject to the multiple changes. Underperforming the index by 0.8% doesn't sound like much but over its lifetime that means an initial $1000 investment would be worth $2,825 versus about $3,190 if invested in an index fund - a difference in terminal wealth of 11%. It is important to note however that those changes include adding a fixed interest dimension which seems reasonable given the fund moved to a 80% equity/20% bond weighting some 10 years or so after its inception My take on the above is that the FMA shouldn't be concerned at these changes as they appear to have been done in good faith. A cynical take however is that the change in asset allocation was an "active" decision

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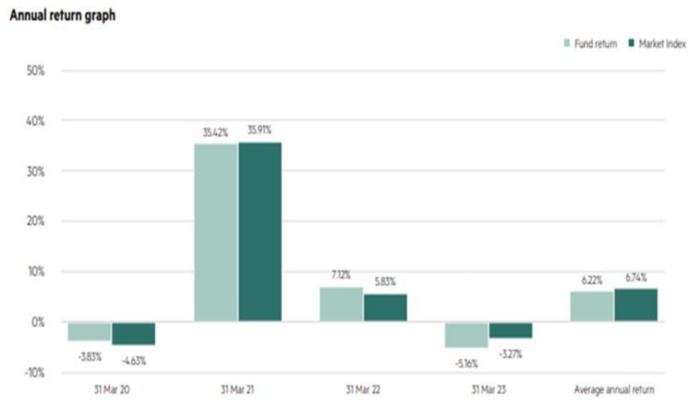
Figure 1



Source: Fund Manager

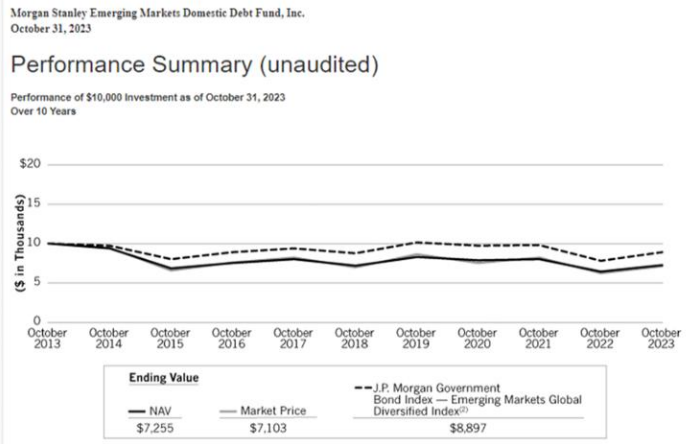
by the fund managers, just like currency hedging is, and a comparison against the original 100% global equity unhedged benchmark is reasonable. Maybe one needs a philosophy degree to do justice to the topic.

I asked the FMA how many changes to a benchmark over a 17 year period would the FMA consider as reasonable for a global equity fund with a consistent investment mandate and whether the FMA had ever raised the issue with any local fund managers? An FMA spokesperson said "The frequency of changes is not, of itself, a breach of any rule. The key question is whether those changes have resulted in benchmarks that are appropriate in terms of assessing movements in the market in relation to the returns from the assets in which the fund invests. If the asset mix of the fund changes, it may necessitate changes to the fund's benchmark. The FMA does not comment on engagements it has with specific entities. It is essential to the FMA's ability to function, and to understand and influence provider behaviour effectively, that our engagements remain between ourselves and providers unless there is a good reason for them to become public. If there is sufficient reason to inform the market/public of our engagements with an individual provider then we will, an example of this would be when we use one of our regulatory tools (a public warning or direction order etc)." Coincidentally the FCA in the UK appears to be having second thoughts about its policy of "stealth regulation ". Here's an excerpt from a policy statement released in late February: "We want to be more transparent about our enforcement activity. Transparency is important. Being more transparent about our work will have a stronger deterrent effect and help to foster public confidence. It shines a light on our operational performance, increasing our accountability and allowing others to hold us to account."

In NZ the Financial Markets Conduct Regulations Act (2014) require that the performance of a fund relative to the benchmark be disclosed by way of a graph to investors. However the legislation in NZ requires this information to be presented as a bar chart and as Figure 1 shows the bar chart example doesn't always do justice in terms of communicating disparities in long-term performance. In the example the reader isn't told the number of years the fund has been going thus has no idea of the significance of the 52 bps pa underperformance. Similarly the high returns in the year ended March 2021 and thus the need to have an extended Y axis reduces the apparent extent of the difference between the fund and the index returns since inception bars. Lastly, the legislation, by my reading of it, requires that, for funds which have been going for 10 years, that the charts include bars for each of these 10 years as well as the since inception return. In Figure 1 above the bar chart is only for four years thus it appears the disclosure is in breach of the Act. Bottom line is that it is pretty obvious that not much thought has gone into this aspect of the regulation. This is particularly unfortunate because all MBIE needed to do was copy the SEC's example.

In the USA, the SEC mandated fund performance versus the benchmark information is communicated via a line chart. This format potentially gives prospective investors a better insight into relative performance, particularly long term returns. As Figure 2 below shows any disparity

Figure 2



Source: Fund Manager

between fund and benchmark returns is reflected in the gap between the two lines, with gap potentially widening the longer the fund has been in operation. However even the effectiveness of this mandate can be impaired by employing an oversized Y axis, as in this case.

The effectiveness of fund return versus benchmark disclosure in NZ is further weakened by the fact that the law only requires this information to be disclosed in funds' quarterly updates which are not read as widely by potential new investors as the PDS. Even worse, for some unknown reason, the fund data has to be after tax and fees. This is inappropriate because the benchmark data is invariably before tax thus preventing any reasonable comparison.

Having said all that the damage from the poor local legislation around disclosure is likely to be limited for the simple reason that most people don't read this stuff and of those that do only a fraction understand it. Instead most non-experts tend to rely on their, often conflicted, "independent" advisors whom they assume will put their interests first. When their advisor works for a vertically integrated company, ie one which owns a fund management business as well as a financial advisory business, there is an obvious conflict. The firm and its advisers can maximise their overall profitability by recommending their own funds and are therefore, despite the statements of regulators, putting their interests ahead of those of their clients.

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.