WEEKLY REPORT AUGUST 2022

Private Asset Management Ltd

Brent Sheather is a Financial Advice Provider and a personal finance and investments writer.

LOWER COST ACTIVE EXISTS

A couple of weeks back we set out the argument that all investors have a responsibility to pay for the cost of price discovery. Everyone benefits from financial markets which are reasonably efficient so its reasonable to expect all players to pay their fair share of the cost of achieving this important function. However, faced with high fees and poor performance relative to benchmarks, it is pretty easy to understand why many rational retail investors would choose to give active a miss and opt for a 100% passive portfolio. But whilst that probably optimizes the solution for the individual it poses a threat to both society as a whole and ultimately one's own fully indexed portfolio: if everybody indexes price discovery ceases to exist and index funds won't work. Today we will set out a possible solution which is relatively easy to implement and won't cost the earth. Importantly it is also consistent with best practice in that most institutional investors opt for a mix of passive and active management in their equity portfolios.

One of the main reasons retail actively managed investment funds underperform the index is due to high fees. A recent study entitled "Fund Selection: Sense and Sensibility" published in the June 2022 Financial Analysts Journal concluded that "active equity funds on average outperform passive alternatives before fees by about the level of the fees". However we should note that the study was only for 12 years – from 2008 to 2020. Relative to funds marketed to institutional investors retail active is very expensive in NZ. The average KiwiSaver growth fund is burdened with annual fund management fees of 1.4% (excluding transaction costs) and these can range from a low of 0.5% to a high of 2.5%. With equities priced to return 7-8% it doesn't take too much analysis to understand the reason so many funds underperform. However lower cost active funds exist – one just has to look for them. Possibly the best way to access low-cost active is via some of the various closed-end funds listed on the NZ, Australian and UK stock markets. Sure there are lots of closed-end funds with high fees but there are also a large number of venerable investment trusts with long histories of successful investing, progressive dividend policies and relatively low fees. This discussion just relates to equities, and in particular overseas equities, as there are no low-cost closed-end funds specializing in NZ equities. I should also disclose that, for a change, I'm talking my book here in that I and my clients own many of the funds mentioned. About half of our global equity portfolios are invested in various UK based, actively managed investment trusts.

So today's story is a brief primer on investment trusts, also known as closed-end funds. Investment trust companies are one of the best kept secrets in the investment world yet produce quite reasonable long-term capital and revenue returns, thanks, in no small part, to their relatively low fees. Investment trust companies (itcs), like unit trusts, are collective investment vehicles that pool your money with that of others and invest it according to declared investment aims, usually in the shares of other companies listed on the stock exchanges around the world.

While every effort has been made to ensure accuracy, no liability is accepted for errors of fact or of opinion herein.

LOWER COST ACTIVE EXISTS

However, unlike unit trusts itcs are themselves companies quoted on the stock exchange. When you invest in an itc you buy shares and become a shareholder just as if you were buying shares in an industrial company like Auckland Airport or Fisher and Paykel. The aim is to provide a return for shareholders, either by investing in those companies likely to pay a continuing flow of dividends, or into companies which have the potential for good capital growth or, in most cases, by a combination of both. Like shareholders in other companies, most investment trust shareholders receive a twice-yearly dividend. Industrial companies normally pay their dividends out of trading profits. Itc's do the same, acting as a simple conduit of revenue, they pay their dividends out of the dividends received from the companies in which they invest. In the UK investment trust companies are obliged to pay out (distribute) to shareholders annually at least 85% of all revenue received in the form of dividends.

Just because not a lot of people know about investment trust companies does not mean that they are tinpot fringe investments; in fact quite the reverse. Investment trusts have been around a lot longer than unit trusts. One of the largest itcs, Foreign & Colonial, was formed back in 1868 and has a stock market value of around NZ$8.5 billion today. Today there are about 380 closed-end funds listed on the London Stock Exchange with a total market capitalization of around £267 bn.

Back in 1990, when I was at Craig and Co, Neil and I became aware of the many advantages that UK based investment trusts had for retail investors. So we began to organise the NZ listing of some of the more popular UK trusts so that New Zealanders could enjoy their benefits whilst still having the simplicity and low cost of investing on the local stockmarket. There are now six UK trusts listed locally and hundreds of NZ shareholders.

Investment trusts have a number of advantages over unit trusts. There is a fundamental weakness in the unit trust structure: when you buy a unit in a unit trust the fund manager issues you with new units and then converts your money into shares. When you want your money out, the fund manager may have to sell shares to pay you out. So the investment strategies of the fund manager are materially influenced by the supply/demand position of the trusts' units and the need for the manager to always keep some cash on hand or to try and predict demands for cash. Think about this for a minute; when everyone is bearish, which is often the best time to buy, the unit trust manager may have to sell shares to fund redemptions. When the market is booming, and caution should prevail, he is swamped with money to invest and obliged to buy at the top of the market. Furthermore in bearish times of low prices the unlisted trust manager must be prepared to fund redemptions quickly and is obliged to retain a higher level of liquidity, often to the detriment of overall performance. The investment trust company manager has none of these problems, because investment trust companies always have a fixed number of shares on issue the manager is able to take a long term view. The managers do not need to worry about keeping cash balances on hand to redeem shares on demand. In some cases the manager may even borrow to buy more shares when the markets are deemed cheap. The manager can therefore carry out the task he has been contracted to do; ie manage the shareholders' portfolio of investments without concerning himself about redeeming or selling further shares.

A second major advantage is that as a shareholder you have the right to participate in major decisions made in relation to that company and have a board of directors who can be held accountable. Because many of the trusts are UK based we benefit from their strict securities regulations and importantly many senior finance and industry leaders, when they retire, often end up on the boards of these companies. Not all are independent of the fund manager but many are and if the manager of an investment trust underperforms itc directors are far more likely to replace them than the timid trustees who ostensibly look after the interests of unit holders in a local managed fund.

While every effort has been made to ensure accuracy, no liability is accepted for errors of fact or of opinion herein.

Lastly, we will look at fees – as we noted earlier whilst some investment trusts have high fees many of the best ones have low fees and are not burdened with the unfair performance fee arrangements so popular in NZ. The table below details the fee structures of some of the lowest cost investment trusts listed on the NZ stock market. Note that the average total fee of 0.45% is roughly one-third that of the average KiwiSaver Growth fund fee of 1.41%. Even this comparison materially understates the relative attraction of many itcs but that's something we will cover in a future column.

LEADING LOCAL INVESTMENT TRUSTS FEE SUMMARY		
	Management Fee	Total Fees
Australian Foundation IC	Internally managed	0.16%
Bankers Investment Trust	0.410%	0.50%
City of London	0.325%	0.38%
Foreign & Colonial	<0.30%	0.54%*
**Has a high weighting in private equity*		

One of the other key differences between investment trusts and unit trusts is that the former frequently trade at discounts, and occasionally premiums, to their net asset value. This is both a risk and an opportunity. It is a risk because, all things being equal, the volatility of an investment trust is greater than that of unit trusts. You could buy an investment trust at a premium of 5% and it could move to a discount of 10% and you would thereby incur a large loss. Conversely the opposite could happen delivering a gain. In two weeks time we will look at why investment trust prices frequently trade below the value of their assets and explain why this situation, rather than being an unexplained anomaly, is actually another example of the market acting rationally, most of the time anyway.

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

While every effort has been made to ensure accuracy, no liability is accepted for errors of fact or of opinion herein.