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ASX's managed fund service is threat to platforms

Graham Hand

It's been a long time coming, but the ability to buy and sell units in managed funds on the ASX is finally upon us. The service was expected some years ago, but according to the ASX, the funds of 65 Foundation Members (fund managers) will hit the exchange within the next few weeks. The ASX has the potential to significantly improve the managed fund investment experience at a lower cost compared with the time-consuming application process required by platforms. This fast and efficient execution creates a new channel for fund managers, especially into the honey pot of SMSFs.

The ASX calls this new distribution channel the 'mFund Settlement Service', and it replaces what was known as Aqua II. Get used to hearing about mFunds.

The view from the ASX

In an exclusive interview with Ian Irvine, Head of Customer & Business Development, and Marcus Christoe, Senior Manager, Funds & Investment Products at the ASX, they made these comments:

Ian Irvine: "Let's start with what it isn't. This is not listing managed funds, the funds remain unlisted. They are not traded between one investor and another with a price set in the market place. The mFund Settlement Service follows the same process used by managers to create and redeem units in managed funds as today. The transaction is from the investor, maybe via an adviser, through an ASX broker via the exchange up to the unit registry of the fund. The orders are placed as a dollar amount and the manager prices the units and they are delivered to the investor in their Chess HIN (Holder Identification Number).

The investor then has a central repository based on the HIN with shares, ETFs, A-REITs, government bonds and now managed funds. They are all administered in the same way. In addition, ASIC recently granted relief and no paper-based applications are required. It's all 'electronic'. Investors don't need to complete that 16 page application form since they've already been identified by their broker. But they still need to be given a copy of the PDS, even though it's online, and we're focussed on educating investors about managed funds."

Marcus Christoe: "They need to acknowledge they've received a fact sheet and a PDS, with a 'tick the box' to confirm. The process cannot continue until this has happened. After the order is placed, the investor is advised that the fund manager will be setting the unit price when they strike the next price. Then it follows a similar process as shares, with a contract note from a broker and a Chess holding statement. It's automation and electronic communications, not bits of paper, grainy identification photos and an application form with AML (anti-money laundering) and KYC (know your client) checks each time. This identification has already happened with share transactions when you first set up an account with a broker and you receive a HIN. That's what we're bringing to managed funds, major efficiencies and savings."

Ian Irvine: "It also fills out the offering for our brokers. They have been immensely successful in selling listed securities to SMSFs, but these direct investors have denied themselves the opportunity to invest in managed funds and access a broader range of asset classes, beyond a domestic equity focus concentrated in banks and large mining companies. It also benefits the fund managers who gain access to this group of investors, and the administration providers who can pull everything in from one system."

Marcus Christoe: "We will have a separate website for mFunds, a new service with aggregated information on all the managers, including lists of MERs, after-tax returns, distributions, copy of the PDS, details on the fund managers. It puts all the information on 65 managers in one place."

Ian Irvine: And in the same way we make market announcements for companies, there'll also be announcements for mFunds. Trustees will be well-informed in one spot. We will have a heavy focus on education, ensuring investors understand managed funds.

The timing is extremely close. We have the most significant regulatory approval. We plan a media announcement within weeks, which will include the 65 Foundation Members and 45 Responsible Entities, or we may announce it in tranches of names."

(End of interview).

Some commentators have called this development a 'game changer', but perhaps it will be more like the ETF experience, which took time to establish itself but has now gained momentum and sustainability, recently passing $10 billion.

The investor experience

Investing in a managed fund on the ASX platform will be similar to buying a stock or ETF. The investor places the trade for a dollar amount, ticks the box which says they have read the PDS, and receives a confirmation. While this is easy for anyone with an existing broker and HIN, a minor drawback is that execution is likely to be on a different page than normal shares, due to the technology links and the need to acknowledge the PDS. This presents a marketing challenge for the ASX and brokers to make clients aware of mFunds.

Compare this with investing in a managed fund on a platform. Find a PDS, print and fill in the 15 page application form in writing, including customer identification. If investing for a SMSF, provide a copy of the trust deed certified by a qualified witness and verification of trustee identification, write the cheque and mail to the fund manager who may receive it a few days later and need to contact the investor if anything is missing. Eventually, the money is invested, and in the meantime, who knows what happened to the unit price. However, once set up, it's not difficult to switch, add or withdraw, and the reporting service, especially on tax, is good.

The Holy Grail for all fund managers is accessing the $500 billion in SMSFs from a million trustees, and mFunds opens this door. It would be rare for an SMSF not to have an existing broker relationship.
Pricing of mFunds versus managed funds

Most boutique fund managers work hard to be added to the major retail platforms such as those offered by Colonial First State, BT and Macquarie. Inclusion opens their funds to the thousands of advisers who use these platforms, and the Business Development Managers (BDMs) at the boutique funds can then target the advisers who use the platforms.

But it comes at a cost. While the platform charges a single Management Expense Ratio (MER), a typical wholesale platform fee of 1% might be split 0.5% for the platform and 0.5% for the fund manager. On wraps, there is a wrap administrative fee added to wholesale fee on the fund.

In the mFund world, the boutique manager can offer its own funds with its own PDS direct to the retail investor without a platform or wrap fee, reducing the cost relative to a platform. For example, a popular

manager like Magellan has its own fund and PDS, but the cumbersome application process is a barrier to the SMSF market. Magellan sees the potential for mFunds to remove this barrier, and give it an opportunity to address the underweight position in global equities of SMSFs. Whether Magellan participates at launch depends on finalising the technical links to the exchange in time. The mFund will have the same cost and features as the fund available directly from Magellan (in fact, it's the same fund) but without the inefficiencies of filling in a new application form and not having reporting under the same HIN.

It also opens the ability for BDMs to market to advisers who are known to have large direct or SMSF businesses, bypassing the retail platforms at a competitive price.

One qualification is that SMSFs are not currently major users of managed funds, comprising less than 15% of their portfolios. The major opportunity may be opening a new distribution channel where SMSFs buy managed funds via the ASX, to the delight of the fund managers, rather than dragging money off the platforms. This is part of the education challenge.

If the fund managers associated with major platforms do join mFund, the price will be their so-called 'mezzanine' or ' A Class' wholesale price, to ensure their own platforms remain competitive.

What do the retail platforms think?

Many of the large fund managers owned by banks which also run large platform businesses will not participate as Founding Members of mFunds. There is a conflict in opening an alternative distribution channel that might push funds away from the platforms, and they see no first mover advantage. The large platforms will watch the progress of mFunds and only participate if resistance is no longer economic.

At this stage, the large retail platforms believe that the ASX and brokers will need to spend a lot of money promoting mFunds to gain market acceptance. While they acknowledge that some of the friction in their application processes will be removed, mFunds require the payment of brokerage and do not offer the same rich functionality of platforms. It is also argued that managed funds are sold and not bought, and need to be accompanied by an advice piece. This is where the strong adviser links will continue to direct money towards the platforms.

But there's an obvious tension here. Within the large bank-related wealth businesses, the fund manager side wants more distribution and involvement in mFunds, while the retail platform side wants to protect its own distribution. It creates tense internal conversations.

Broader market implications

The main appeal of mFunds is the simplicity and efficiency of execution. An investor can have a portfolio of index-based ETFs matched with actively-managed mFunds transacted in a single operating model. Many SMSFs like this direct world of electronic feeds, online research and execution, and eschew the world of paper, cheques and snail mail where possible. The ASX is well-placed both to participate in and encourage the move to direct.

The recent introduction of super wraps by a large number of industry funds to counter the SMSF threat and give their clients access to ASX securities has been at the expense of managed funds, and there is potential to address this.

And as more financial planners switch their business models from commissions to fee-for-service, many are changing to listed investments, but they have a familiarity with the managed fund world of platforms. They will now be able to use many of their favourite fund managers in mFund format.

The potential winners from mFunds are the ASX, brokers, fund managers, SMSF administrators, SMSFs and other direct investors and planners who have moved into the online space. The potential losers are the large platform providers, fund managers who are not allowed to participate and maybe ETFs, who now have online competition. But there's a long way to go before the major platforms with their massive adviser support are forced to reconsider their own business models.

Make 'automatic' investing your first item of expenditure

Noel Whittaker

If your week has been like mine, it's been a frustrating one. You arrive back at work full of enthusiasm after a well-earned break but find all the plans you made over the holidays have to be put on the back burner as you face the myriad of jobs that have been piling up in your absence. In a twinkling of an eye, the sickening realization hits that January is already over and you're stuck in the same old routine as last year.

This happens because it is human nature to attend to our commitments but to procrastinate over everything else. This is the reason people find it much easier to exercise with a friend or under the guidance of a personal trainer. Most of us will never get out of bed to exercise on our own, but will always keep an appointment to exercise with somebody else.

The secret of building wealth is to make financial commitments and then put a strategy in place to ensure they happen automatically. To do this, you have to change your habits so you start to spend your salary in the correct order. Most people do it the wrong way. They get paid on Friday, fill the car up with petrol and then probably drop in to the bottle shop and the video shop on the way home. The next day, they do the grocery shopping and, if they're doing this at a large shopping centre, may well fall into the trap of buying a few unnecessary knickknacks as part of the shopping expedition. Their loan repayments are deducted automatically from their bank account and by some strange but inevitable process, they arrive at next payday with nothing left over to invest. They resolve that next week will be different, but it never is.

This ability to spend exactly what one earns is one of the real mysteries of life. Petrol prices and interest rates can rise and fall, and groceries always go up, yet this inbuilt computer in our brain continues to automatically adjust our spending so that our expenditure runs in line with our income. This is the reason pay rises seldom make much difference to anybody's financial situation.

Time and time again at seminars I have asked all those who have paid off a loan to put their hands up. The result is a sea of hands in the air. Then I say "keep your hand up if you invested without fail the payments you didn't need to make any more." All the hands sink and there are sheepish grins everywhere. Of course they meant to do it but simply never got around to it.

The solution is simple – make investing the first and most important item of your expenditure instead of something you try to do when you get around to it.

For those paying off their house, increasing the payments by just $400 a month could make a substantial difference. Imagine a couple paying off a $300,000 loan over 30 years at $1,800 a month. The extra $400 would chop 10 years off the loan and save them $142,000 in interest.

Of course borrowing for investment is the best way of all because a relatively small monthly payment puts a substantial amount of quality assets at work for you. A tax deductible $300 a month (that's just $69 a week) would enable you to take out a loan to buy $50,000 worth of blue chip share trusts. If they achieve 10% per annum (income and growth combined) they would be worth $400,000 in 25 years. That would be a great boost for your retirement.

If you have only a small deposit and don't qualify for a margin loan or a home equity loan talk to an adviser about a regular gearing plan. This is where you invest a set sum each month into a share trust and a lender adds a borrowed amount to it. You decide how much you will borrow each month, but it must be no more than twice your own investment. For example if you decide to invest $500 a month, the bank would match it with up to $1000 of loan money. Therefore you are investing $1500 a month – of which $1000 is borrowed. After 60 months you have invested $90,000 of which $30,000 is your own money and $60,000 is borrowed.

Alternatively, and usually cheaper and easier, you can direct debit into an internally geared share fund, which usually borrows about $1 for each $1 put in. The fund finances at wholesale rates, currently costing less than 4% compared with regular gearing plans at around 7.5%. In this case, there is no investor discretion on the amount borrowed.

Lastly, try to ignore short term market fluctuations and rely on longer term compounding and a rising market over time.

Simple? Of course it is, but most people never get around to starting. The good news is that once you put the process in place by direct debit you can virtually forget about it.

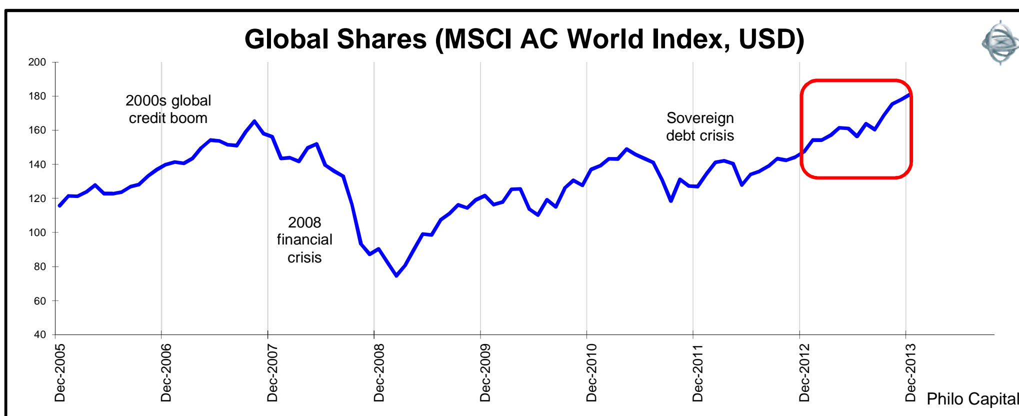
Noel Whittaker is Australia's foremost financial adviser, a well-known media commentator and international best-selling author. He is currently Adjunct Professor with the Faculty of Business at the Queensland University of Technology.

Global stock markets in 2013

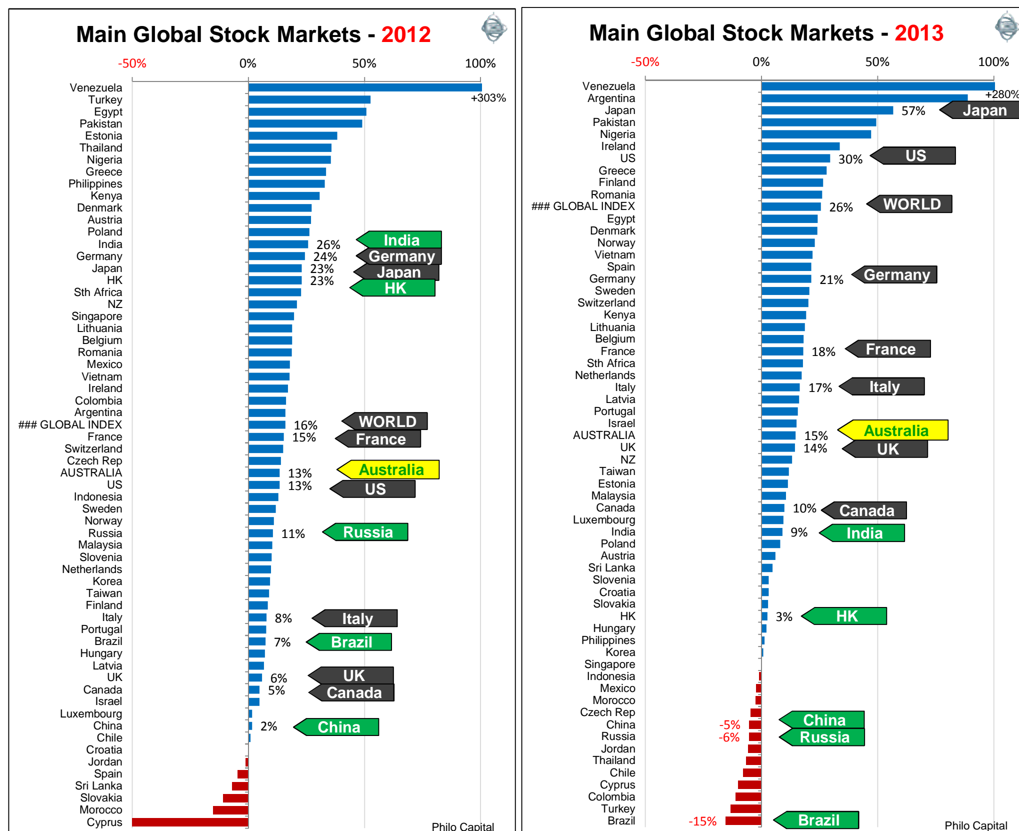
Ashley Owen

In 2013 stock markets around the world continued their rebound that began in late 2011 and early 2012, following the 2011 dip that was triggered by the European banking and debt crisis and the US credit downgrade. In 2013 the only minor dips for global stock markets were the Cyprus bank bailout crisis in March and the QE taper scare in May-June.

Our first chart shows the global total return index (including dividends) in US dollars since 2005:



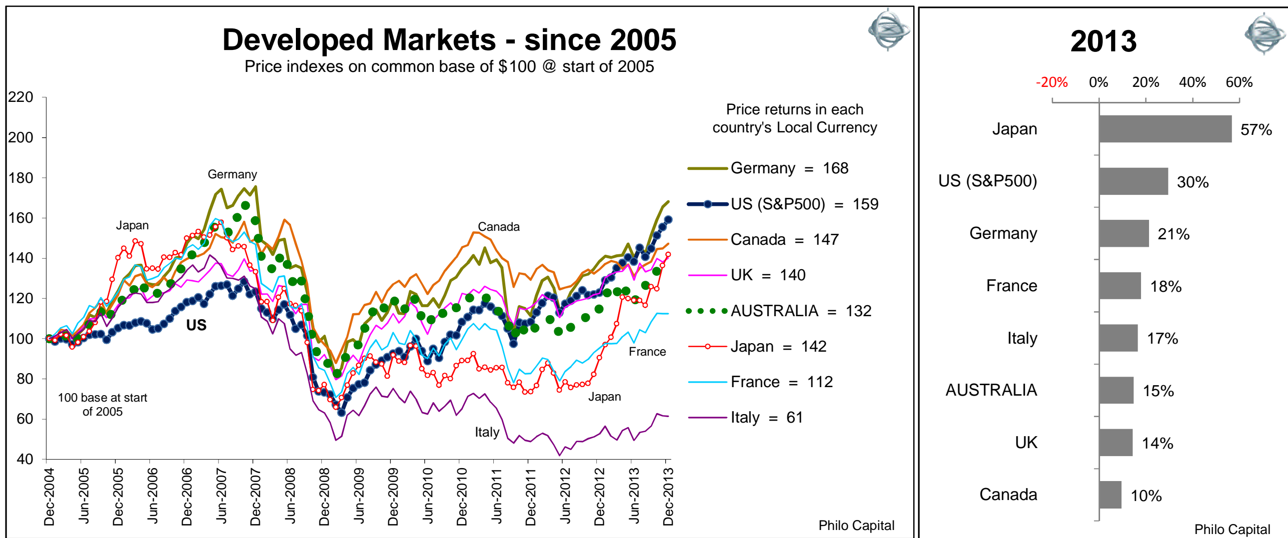
The following charts show broad stock market indexes for the main global markets for 2012 and 2013:



In 2011 earnings and dividends were up in most countries but stock market indexes were down almost everywhere.
In 2012 earnings were down in most markets and dividends were flat or down in most markets, but market indexes were up almost everywhere.

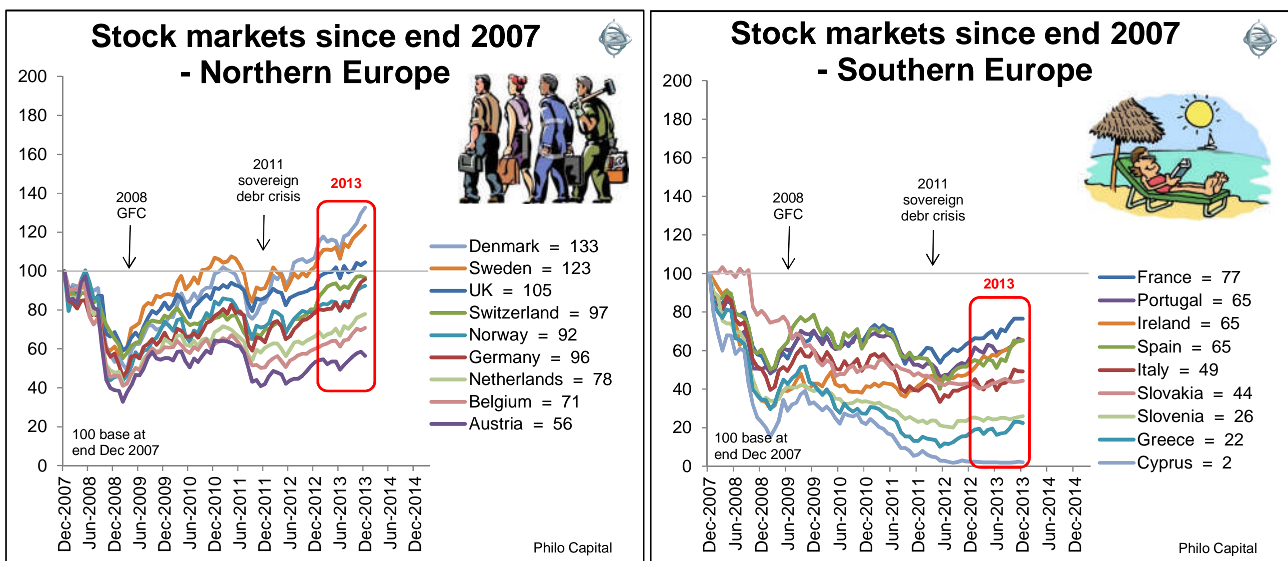
In 2013 almost all developed markets were up, although earnings were weak and their economies were still on life support in intensive care wards, supported by extremely loose fiscal and monetary policies. Meanwhile, the far more fiscally sound and faster growing large emerging markets were suffering the effects of domestic slowdowns, rising inflation and poor equity returns.

Developed Markets:



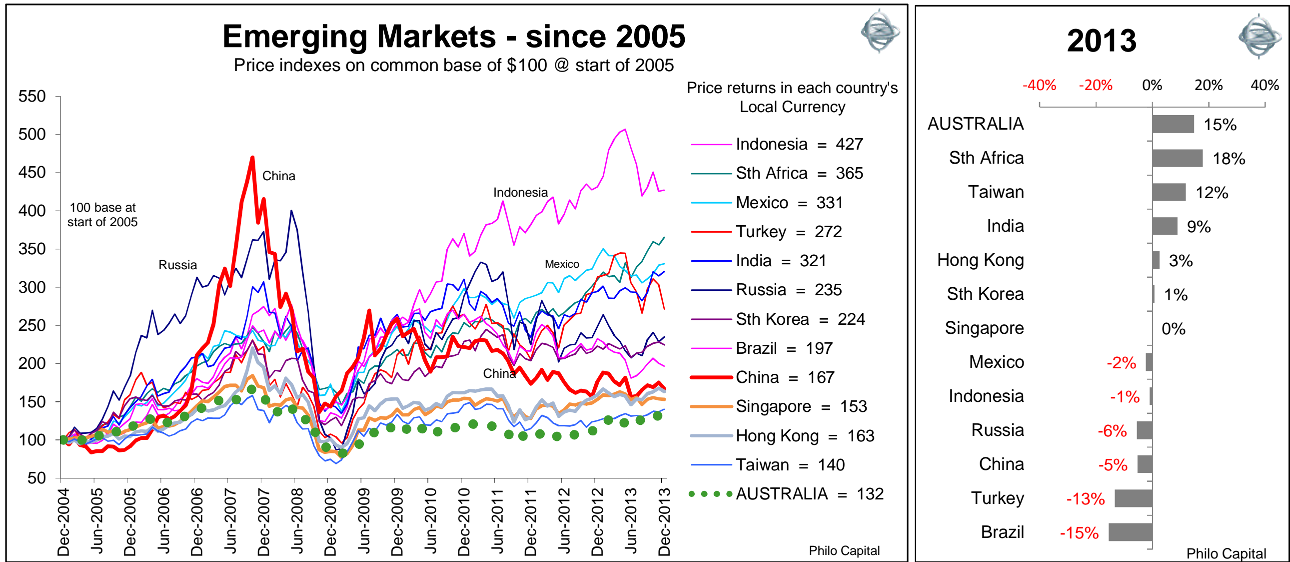
The 2012-2013 rally was led by the big industrial giants - US, Japan and Germany - driven in each market by cyclical companies such as industrials, retailers, media and banks.

European markets showed a pronounced divergence between the so-called 'industrious' north and the so-called 'profligate' south.



Despite this divergence, virtually all European markets rebounded strongly in 2013 (apart from Cyprus and Slovenia with their banking crises). Even Greece has rebounded strongly since its first and second bailout, even as it heads for yet another bailout.

Emerging Markets:



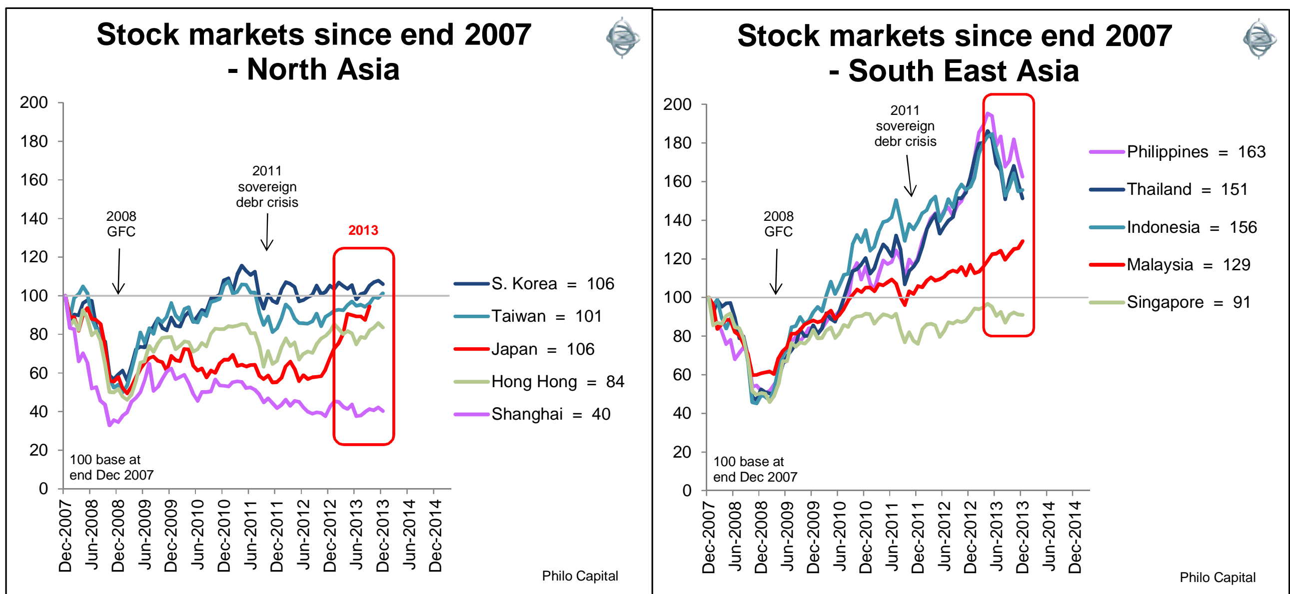
(Note the vertical scales on the charts for developed markets and emerging markets are very different in order to show the much larger swings in the emerging markets. All emerging markets except Taiwan have outperformed the developed markets and Australia by big margins through the pre-GFC boom, through the GFC itself, and in the post-GFC recovery.)

The worst of the main emerging markets have generated similar returns to the best of the main developed markets over the period, so if all markets were shown on the same chart, all of the emerging markets (aside from Taiwan) would appear above the best of the developed markets.

Emerging markets have been much more volatile and have been very vulnerable to the 'hot money' effect as money rushes in and out of global markets in 'risk on/risk off' swings. We saw this in the capital flight in the wake of the May-June 2013 Bernanke QE scare, and again in December as the QE taper plan was finally announced.

The south-eastern Asian markets were hit hard in the global capital flight due to the QE taper scare but most are far better placed now than they were when the 1997 Asian currency crisis hit.

As in Europe, there is a diversion between north Asian markets (driven largely by China) and South-East Asian markets (which are less reliant on the China supply chain). This is very evident in the following pair of charts:



In 2013, as in the past few years, the BRICs (Brazil, Russia, India and China) were the laggards, with their slowing economies, inflation problems and highly concentrated stock markets dominated by state-controlled enterprises.
The term 'BRIC' was a brilliant marketing gimmick invented by Goldman Sachs ten years ago to sell stocks and consulting services. However the BRIC markets have generally been a disaster for investors. As investors, we see the BRIC phenomenon more in line with the J P Morgan term: 'BRIC: **B**loody **R**idiculous **I**nvestment **C**oncept'.

Our consistent advice for investors over the past several years has been: "The further away from China you are the better".

Ashley Owen is Joint Chief Executive Officer of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund.

What's that UBS bond benchmark in the annual statements?

Warren Bird

Fund managers are currently sending out annual statements to their investors, including information on how their funds have performed. Typically, the fixed interest returns will be compared with something called the 'UBS Composite Bond Index'.

However, most of those investors probably don't know what that index actually means, or how it came to be the standard for comparing funds. During my years as a fixed interest fund manager I was often asked to explain the nature and origin of this mysterious benchmark.

So who or what is 'UBS'?

Most do not know the corporate history of the venerable merchant bank Dominguez Barry Samuel Montague (DBSM) since the 1980s. The UBS indices are simply the modern version of the DBSM bond indices. Through the 1990s the firm changed its name many times, and so did the suite of bond indices that it maintained. Most of the names had SBC in them, which became UBS in 1998 when the Union Bank of Switzerland took over Swiss Bank Corporation.

A legitimate follow-up question is whether this gives UBS Asset Management any sort of unfair advantage in managing bond funds. The answer is definitely no. I can say this with confidence, having worked with them from 1993-96 and also from understanding how the bond index calculation process works. The indices have been maintained for many years now by the capital markets/broking side of the business, which deals with all fund managers in the market. UBS Asset Management has no influence over the valuations used for any of the bonds in the index or the performance of the index.

The meaning of composite unravelled

What about the use of the word 'composite' in the name of the index?

The index is made up of bonds in the market, not just an index of Commonwealth government securities (CGS). It includes debt issued by a wide variety of issuers, including state government authorities, local companies and foreign entities that choose to raise money in Australian dollars.

That's the simple answer. But there's a more detailed explanation of why an index like this was produced which needs a history lesson in Commonwealth-state financial relations.

Prior to the mid-1980s the only bond market of any substance in Australia was for CGS. Apart from state government utilities like the NSW Electricity Commission, the Commonwealth undertook all borrowing on behalf of the states and on-lent the proceeds to them.

Then, at the Loan Council meeting in 1984, a package of measures was introduced to bring greater national control over the level of public sector borrowing. All borrowing by state entities was brought under the Loan Council oversight and limits for total annual borrowing by the states were determined. Under this global approach, the states would now borrow for themselves and on-lend to their own departments and agencies.

This led to the establishment of the state Treasury corporations to undertake the borrowing and to manage the internal lending to the various arms of government that needed funding. These institutions are what we now know as the semi-government authorities (or 'semis' for short).

At this point, Dominguez Barry entered the picture. Merchant bankers Jim Dominguez and Rob Barry saw the opportunity for their investment bank to help the semis get established, to originate and to market their debt securities and to encourage the development of this new bond market in Australia. (UBS is still a leading firm in the semi-government market.)

As part of the strategy they established a funds management business to invest in a portfolio that would include semis as well as CGS. They needed a performance benchmark that was a composite of these two sectors, in contrast with another index produced at the time, the Commonwealth Bank's Australian Bond Index, which only included CGS.

As the market has evolved, with new issuers coming along, the index has also developed. It is now a composite of four sectors, each of which has its own index for performance and analysis purposes. The sectors are:

1. UBS Treasury Index, which is CGS only
2. UBS Semi-government Index
3. UBS Credit Index, which includes investment grade corporate bonds
4. UBS Supra/Sovereign index, which includes supranational issuers like World Bank and other Government guaranteed bonds.

Returns beat the benchmark

The fund manager statements that are now being sent out will show that the return from the UBS Composite Bond Index in 2013 was 1.99%. Individual fixed interest funds will be compared with this benchmark return and some explanation given for the relative performance.

From what I've seen, most fixed interest funds did quite well in 2013 and outperformed the Composite. This was mostly because almost all active managers were underweight in Commonwealth bonds and overweight in semis and corporates. The UBS semi-government index returned 2.52% in the year, and the UBS Credit index delivered 4.32%, compared with the Treasury index return of only 0.27%.

Another factor for managers who outperformed in 2013 is most likely a short duration strategy. Because this was a year in which yields rose, longer duration bond returns were reduced by the decline in capital value that goes with higher yields in the short term. Within the UBS Composite, the zero to three year maturity component returned 3.4%, but the 10 year and longer component was -2.7%.

Although it's not the only index used by Australian fixed interest fund managers, the UBS Composite is the most popular. It is a comprehensive benchmark including the full range of investment grade securities available in the local market; it has a track record back to the mid-1980s; and information about its performance is readily available to all professional fund managers.

It is the fixed interest world's equivalent to the All Ordinaries or S&P/ASX 200 that are used to benchmark share fund performance. And I think it has a fascinating history.

Warren Bird was Co-Head of Global Fixed Interest and Credit at Colonial First State Global Asset Management. His roles now include consulting, serving as an External Member of the GESB Board Investment Committee and writing on fixed interest.

Standing on the shoulders of giants

Joe Maisano and Dr. Alex Radchik

This little journey through fund analysis history provides some background into the basis of modern portfolio analysis and reporting techniques. Although the work of these pioneers in our industry is up to 60 years old, it is still taught in universities and finance courses as the foundation of modern funds management.

In 1990, William F. Sharpe was awarded the Nobel Prize in Economics, along with Harry Markowitz and Merton Miller "for their pioneering work in the theory of financial economics". Markowitz, often referred to as the father of Modern Portfolio Theory, did not invent the idea of portfolio diversification, which can be traced back to Shakespearean times (see The Merchant of Venice, Act I, Scene I). His key contribution was the idea that while risk can be reduced through diversification, it cannot be completely eliminated. In his seminal 1952 paper "Portfolio Selection", he was the first to formulate a mathematical model for the diversification of investments. This model demonstrated that what was important was not the riskiness of any individual investment, but rather the contribution that the asset made to the risk of the overall portfolio.

Sharpe built upon this foundation to develop the Capital Asset Pricing Model (CAPM) in 1964. This model utilised a linear regression approach with Beta as a measure of the sensitivity of an asset's return to the return of the market and Alpha as a measure of the excess return for the risk incurred. Both parameters were used to calculate a fair-value rate of return of a risky asset.

Like all good ideas in finance, it wasn't long before others contributed to improvements. Indeed, Sharpe was not alone in formulating such ideas as Jack Treynor, John Lintner and Jan Mossin had independently come to similar conclusions. In 1972 Fischer Black (of Black-Scholes option-pricing fame) improved the CAPM model and it became widely used as a model for pricing individual securities. Later the Black-Litterman model was introduced which incorporated an investor's subjective views on the market trends which may influence return levels.

In late 1988, William Sharpe took the ideas to the next level in the article "Determining a Fund's Effective Asset Mix". In this article, Sharpe introduced the idea of 'attribution analysis', later dubbed returns-based style analysis (RBSA). In the CAPM model, we can look at the return of an asset with respect to the return of the market. If we consider that any single index is a representation of the 'market' for this 'style' of investment, we can thus calculate exposure to this market. If we then use a number of indices to represent different markets, we can assess the exposure to various markets based on the returns of our portfolio. From here, we can assemble a 'style portfolio' being a portfolio of our indices, weighted by the exposure we have determined that we have to each. The style portfolio will usually not explain 100% of the fund returns (as the fund might hold a mix of assets in each market different to that of each index), however a well-fitted style portfolio should explain the returns to a high level. We can use a measure of fit such as an R-squared statistic to see just how close we are to matching the original portfolio returns.

The immediate practical applications for this model were obvious, as it allowed an investor to analyse a fund's underlying exposures. If the underlying holdings are unknown, this can help the investor understand what the fund is doing and where it is exposed. If on the other hand the holdings are known, the analysis can uncover 'hidden' exposures (for example the share prices of an Australian company that imports food could be exposed to the Brazilian market).

In 2002 Michael Markov developed and patented a new version of RBSA called 'Dynamic Style Analysis'. This innovation was designed to improve the capture of changing weights in the portfolio (i.e. a fund will generally not have static holdings throughout the year, but will rebalance the portfolio in response to market conditions). Such changing asset weights add a further level of complexity to the style analysis, as we now have to explain not only which exposures are present in the portfolio, but also how these exposures have changed over time.

Although research continues in the development of new modelling techniques, such research is often based on the work done by those mentioned above. We now have available to us some sophisticated tools to gain an understanding of funds for which we do not have full disclosure of holdings, to perform due diligence of funds we are considering investing in, to break funds down to their component exposures and even to identify hidden exposures in portfolios.

In the words of Sir Isaac Newton, "If I have seen further it is by standing on the shoulders of giants."

Joe Maisano is a Director and Dr. Alex Radchik is a Project Consultant at Trading Technology Australia (TTA). TTA is the Australian representative of Markov Processes International, the developers of MPI Stylus Pro™.