UNIT TRUSTS: BEST OPTION FOR INVESTORS?

Those of you who have read my articles in the past will know that I am an avid fan of the unit trust industry, especially when compared to life assurance investments. For investors who do not want to select their own shares or ETF's, there are few better options than a well-managed, low cost unit trust. Unfortunately, the industry is not perfect, there are some operators who take advantage of some of the loopholes in the legislation to charge clients unfairly. Fortunately, the regulators are working hard on tightening up on the legislation to protect investors. In the interim, here are some guidelines to protect you from what I believe, are unfair charges.

WHO IS IN CHARGE?
In researching this article, I spent some time emailing and speaking with ASISA, this is the body that represents the investment and insurance industry. They do not represent investors but they are working hard to ensure that the industry is constantly improving. To that end, I was deeply impressed with them and especially their CEO, Leon Campher, who is very aware of the industry's shortcomings and is trying to correct them in conjunction with the FSB. It is important to note that ASISA is not a regulatory body; they cannot create or enforce legislation. That is the ambit of the Financial Services Board (FSB). My view is that the FSB has a good understanding of the unit trust industry but is sometimes a bit slow in implementing changes. For the industry, one would prefer a regulator that takes time to understand the issues before making changes. If they were to make ill-considered decisions, they could unwittingly destroy the industry.

UNDERSTAND YOUR RISK
To understand your potential investment risk in unit trusts, you need to know how much your fund can invest in shares and listed property. These are two of the asset classes that carry the most risk with the potential to deliver the best return. Usually, you can determine this by looking at the fact sheet of the unit trust. This is the document that tells you about the fund, its benchmark for performance, the fees and what it can invest in. The fact sheet should tell you how much of the fund can be invested in shares e.g. between 40% and 75%. If the fact sheet does not explain this clearly, don't invest in the fund. One of my concerns about the unit trust industry is that the fact sheets are not uniform; Campher assures me that this will be rectified in 2013.

BE CAREFUL OF FLEXIBLE FUNDS
To me, the category of unit trusts that is most open to unfair treatment of investors is the flexible category. These are funds that can invest in anything from 100% cash to 100% equities. Whilst there are some good funds in this category, some managers are using this flexibility to charge performance fees that are relatively easy to earn. The way to do this is to charge a performance fee that is based on an interest rate-linked benchmark. As an example, the fund could have a benchmark of Prime or the Repo rate. A benchmark that is linked to an interest rate is quite easy to beat over the longer term if you invest only in shares. This is because shares (as measured by the All Share Total Return) have

outperformed inflation by 7.5% per year over the very long term. By contrast, cash has outperformed inflation by 1% per year over the long term.

Interest rate benchmark vs. All Share Index Total Return

	Repo Rate	All Share Index Total Return
1 year	5.42%	18.0%
2 years	5.50%	17.44%
3 years	5.91%	15.48%
5 years	7.72%	7.33%
7 years	7.82%	15.78%
10 years	8.32%	17.23%
Inception	9.05%	16.56%

Source: Morningstar

Even if a fund manager creates a benchmark that beats a particular interest rate by 2% or 3% per year, the manager can be assured of earning performance fees over most periods longer than 3 years. This can be seen in the table above where shares have beaten an interest rate benchmark over most periods since 1998. This means the fund manager will almost always earn a performance fee and in my opinion, this is unfair to investors.

If the fund manager also manages to choose good shares (or is lucky) the fund could achieve a good ranking in its sector. This represents a great marketing opportunity because the fund manager can then advertise the high ranking and might even get free publicity from the financial press. As we have seen in the past, a fund that obtains a high ranking in its sector will often attract new money from investors who chase performance rankings. Sadly it is often unsophisticated investors and lazy advisors who recommend highly ranked funds to their clients.

If ASISA believes a fund is exploiting investors, they will address this issue with the fund manager concerned. If the manager ignores them, they will then notify the FSB who will hopefully take action.

My primary concern is that I believe fund managers should change the benchmark for performance fees so that it aligns with the underlying investments that will be made in the fund over the long term. If the fund then beats a fair benchmark, the manager should be entitled to a fair share of the profits.

BROKER FUNDS

My other concern in the industry relates to financial planning companies who have their own unit trust funds – called broker funds. Usually, these are unit trusts that invest in other unit trusts, called Fund of Funds. There are some good Fund of Funds in the industry but very often broker funds exist to enable financial planners to earn an asset management fee + an advice fee.

I feel that a great advisor cannot also be a great fund manager, there is an inherent conflict of interest that can compromise the advice you receive. As an example, if my company has its own unit trust and I advise you to invest in it, how do you know that it is the best fund for you? When the fund performs poorly, it would not be in my financial interest to advise you to move to another fund because I will no longer earn the fund management fee. This is something that the FSB and ASISA are aware of. I would suggest you view any fund owned/managed by your advisor with a critical eye. If your advisor recommends a fund of funds owned by his employer then ask him to reduce either your advice fee or fund management fee. This would ensure that the potential conflict of interest is removed.

These are two areas of concern in an industry that is otherwise doing a great job in providing transparent and low cost investment solutions for investors in South Africa.