IMPERIUM CAPITAL

momentum

Navigating fund fees and finding value

Global Matters Weekly

22 August 2022

– **Gary Moglione**

As investors in the investment trust market, we have seen the UK market grow significantly over the years. In addition to diversification and access to many asset classes not usually available to retail investors, closed-ended trusts have significantly outperformed open-ended funds over the long term. In the UK, over the ten years to September 2021, the average investment company returned 265% versus the average open-ended fund returning 70%. The AIC provides a good article explaining the benefits of the closed-ended structure.

https://www.theaic.co.uk/financial-advisers/guides/investment-company-performance-vs-oeics

However, new regulations in the UK are making it increasingly difficult for multi-asset funds to hold investment trusts. This is because we are having to report much higher fees for these vehicles in the form of "other ongoing costs" than we otherwise would with directly held equities or funds, thereby making our own UK funds seem more expensive.

Let's consider an example of two investment vehicles with no assets other than £100m to invest. One is a listed UK Equity, the second is a closed-ended vehicle. If each vehicle uses their £100m to buy the same asset what would a multi-asset fund reportable cost be for holding each vehicle? The UK Equity would have zero cost, as we would not have to report "look through costs". Meanwhile, in addition to the management fee, the closed-ended vehicle would have to report indirect ongoing costs such as board costs, auditor fees, marketing costs, transaction fees, finance costs etc and borrowing costs. The result often leads to reported costs of 2 to 3%. Most of these "look through costs" would also be incurred by the UK Equity but are not reportable under the current regulations.

Therefore from a cost reporting perspective, it is more beneficial to hold direct equities than closed-ended vehicles, despite the strong performance and structural advantages. It creates a perverse incentive to keep costs down by holding investments that may not have the best total return prospects.

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Most of our property exposure is in closed-ended vehicles (real estate investment trusts or 'REITs'). The reported costs are higher than direct equities, such as British Land or Property Funds, but the structure is much more efficient for investing in property. As a result, our closed-ended holdings within the VT Momentum Diversified Income fund that were launched over five years ago have an annualised return of +8.23% versus the average open-ended property fund +3.96% and British Land -1.62%. If cost had been the deciding factor, British Land would have been chosen, resulting in 10% per annum lower returns.

Cost is an important component of returns, so should factor into investment decisions. However, one must consider these various reporting methods to make an accurate comparison. You should also consider what parts of the reportable cost are simply investment managers taking fees and what part are drivers of additional returns. An example is our holding in AEW REIT. It is closed-ended and has a reportable cost of 3.41%. Just 0.9% of this is the management fee, the rest is made up of running costs of the properties, finance costs etc. This year they have realised significant value by developing and selling numerous properties. Despite the high reportable cost, the trust has returned 16.6% after costs over the past year.

In summary, UK fee disclosure regulations create uneven comparisons and risk encouraging investors toward lower reported cost vehicles, rather than investments that have the best risk/reward. An additional complexity is that to date only a proportion of open-ended funds have adopted the new fee disclosure proposals to include closed-ended vehicles, making it difficult for investors to make like-for-like comparisons across funds.

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The Marketplace

- Global equities fell by 1.6% last week
- In Ukraine, talks with President Zelensky, UN Secretary-General António Guterres, and Turkish President Recep Tayyip Erdoğan were held in Lviv with Turkey acting as the key interlocutor between Ukraine and Russia
- Brent crude fell by 1.5% over the week to $96.7 a barrel
- Gold fell by 3.1% to $1747.1 per ounce

Market Focus

US

- US equities returned -1.2% last week
- The Empire State manufacturing survey plunged to -31.3 in August (vs. 5.0 expected), marking its worst performance since the Global Financial Crisis (GFC), apart from April and May 2020
- The National Association of Home Builders' housing market index for August, fell to its lowest level since May 2020 at 49 (vs. 54 expected)
- Housing permits beat expectations (+1674k vs. +1640k) while starts fell to their slowest pace since February 2021 (+1446k vs. +1527k expected)
- Industrial production climbed +0.6% month-over-month (vs. +0.3%), with capacity utilisation hitting its highest level since 2008 at 80.3%
- US retail sales came in very slightly beneath expectations, with an unchanged reading in July (vs. +0.1% expected)
- Initial jobless claims fell to 250k (vs. 264k expected)
- Continuing claims, a leading indicator for recessionary risk, also came in below expectations at 1437k (vs. 1455k)

Europe

- European equities returned -0.9% last week
- Germany announced that planned nuclear facility closures would be "temporarily" postponed in light of climbing consumer prices
- Germany's economic sentiment Zentrum für Europäische Wirtschaftsforschung (ZEW) survey fell to -55.3, its lowest level since October 2008, at the depths of the GFC
- The second reading of Q2 Gross Domestic Product (GDP) for the Euro Area came in at +0.6%, a tenth beneath the initial estimate

UK

- UK equities returned +1.0% last week
- In the UK, regular pay (excluding bonuses) fell by -3.0% in real terms over the year to April-June 2022, its fastest decline on record
- UK inflation rose to +10.1% in July (vs. +9.8% expected) which means inflation is now in double-digits for the first time in 40 years
- Retail sales fell by 3.4% year-on-year in July (vs -3.3% expected)

Asia/Rest of The World

- Global emerging market equities fell 1.5% over the week
- Japanese equities rose by 1.1% over the week
- Japan's headline inflation rose 2.6% year-on-year in July, in line with market expectations and against a 2.4% rise in June
- Data from Japan showed that exports rose 19.0% year-on-year in July (v/s +17.6% expected) posting 17 straight months of gains, while imports advanced 47.2% (v/s +45.5% expected) driven by global fuel inflation and a weakening yen
- Japan reported a trade deficit for the 14th consecutive month, swelling to -2.13 trillion yen in July (v/s -1.91 trillion yen expected)
- Canadian inflation slowed to 7.6% YoY in July in line with estimates, while the average of core measures climbed to a record 5.3%
- Australia unexpectedly reported a drop in employment of -40.9k in July (vs. +25k expected).

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Asset Class/Region	Currency	Currency returns			
		Week ending 19 Aug. 2022	Month to date	YTD 2022	12 months
Developed Market Equities					
United States	USD	-1.2%	2.5%	-10.7%	-3.0%
United Kingdom	GBP	1.0%	2.2%	7.6%	14.1%
Continental Europe	EUR	-0.9%	-0.1%	-10.9%	-7.1%
Japan	JPY	1.1%	2.8%	1.5%	7.7%
Asia Pacific (ex Japan)	USD	-1.4%	0.4%	-15.3%	-14.9%
Australia	AUD	1.4%	2.7%	-2.1%	-0.8%
Global	USD	-1.6%	1.6%	-12.8%	-7.6%
Emerging markets equities					
Emerging Europe	USD	-3.4%	1.7%	-76.5%	-76.9%
Emerging Asia	USD	-1.1%	0.5%	-17.9%	-16.9%
Emerging Latin America	USD	-3.6%	4.9%	8.8%	1.4%
BRICs	USD	-1.4%	0.5%	-19.6%	-22.0%
China	USD	-2.0%	-2.0%	-21.3%	-25.1%
MENA countries	USD	0.6%	3.6%	7.4%	11.5%
South Africa	USD	-7.4%	-0.3%	-7.4%	-4.9%
India	USD	0.0%	3.0%	-3.5%	1.0%
Global emerging markets	USD	-1.5%	1.1%	-16.9%	-16.4%
Bonds					
US Treasuries	USD	-0.7%	-1.7%	-8.9%	-9.9%
US Treasuries (inflation protected)	USD	0.0%	-1.4%	-6.9%	-5.0%
US Corporate (investment grade)	USD	-1.2%	-1.5%	-13.0%	-13.7%
US High Yield	USD	-1.2%	0.4%	-8.8%	-7.2%
UK Gilts	GBP	-2.3%	-4.2%	-15.9%	-18.2%
UK Corporate (investment grade)	GBP	-2.1%	-3.2%	-14.1%	-16.2%
Euro Government Bonds	EUR	-1.9%	-3.0%	-11.3%	-13.7%
Euro Corporate (investment grade)	EUR	-1.6%	-2.1%	-9.7%	-11.2%
Euro High Yield	EUR	-1.0%	0.7%	-9.5%	-9.7%
Japanese Government	JPY	0.0%	0.4%	-2.1%	-2.6%
Australian Government	AUD	0.2%	-2.0%	-8.8%	-12.2%
Global Government Bonds	USD	-2.0%	-2.7%	-14.9%	-17.5%
Global Bonds	USD	-1.9%	-2.5%	-14.7%	-17.0%
Global Convertible Bonds	USD	-1.6%	1.5%	-17.3%	-19.2%
Emerging Market Bonds	USD	-2.1%	-0.9%	-24.4%	-26.1%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
		Week ending 19 Aug. 2022	Month to date	YTD 2022	12 months
Property					
US Property Securities	USD	-2.2%	0.5%	-13.2%	-2.5%
Australian Property Securities	AUD	-0.2%	-2.7%	-18.5%	-10.1%
Asia Property Securities	USD	-0.9%	-2.1%	-7.2%	-12.0%
Global Property Securities	USD	-2.5%	-0.7%	-14.5%	-9.7%
Currencies					
Euro	USD	-2.2%	-1.6%	-11.9%	-14.1%
UK Pound Sterling	USD	-2.5%	-2.8%	-12.6%	-13.4%
Japanese Yen	USD	-2.4%	-2.6%	-16.0%	-19.8%
Australian Dollar	USD	-3.3%	-1.4%	-5.5%	-4.0%
South African Rand	USD	-4.7%	-2.1%	-6.3%	-10.8%
Swiss Franc	USD	-1.8%	-0.7%	-5.0%	-4.4%
Chinese Yuan	USD	-1.1%	-1.1%	-6.8%	-4.7%
Commodities & Alternatives					
Commodities	USD	-1.6%	-0.9%	23.1%	40.1%
Agricultural Commodities	USD	-2.6%	0.7%	7.2%	18.8%
Oil	USD	-1.5%	-12.1%	24.4%	45.6%
Gold	USD	-3.1%	-1.1%	-4.5%	-2.0%
Hedge funds	USD	0.4%	1.1%	-3.4%	-2.8%

Source: Bloomberg. Past performance is not indicative of future returns

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