Global Matters Weekly

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Navigating fund fees and finding value

by 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.

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.

Source
Unless stated, all other figures sourced from Bloomberg Finance, L.P.

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