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General stocktake of fund updates

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Background

Purpose

Quarterly fund updates (fund updates) let investors know important information about their managed fund, such as how it is performing, what it is costing them, and what their fund is investing in. By law[1], they must follow a standard format designed to make it easy to compare funds, and be understood by non-expert investors. Fund updates must be produced and made publicly available on a quarterly basis.

The legal requirement to produce (and make publicly available) information such as quarterly fund updates is relatively new for managed investment schemes (MIS), with the first complete year of quarterly fund updates produced in 2017.

We decided to undertake a general stocktake (or review) of these fund updates to discover if there were:

- Common themes or issues and potential areas where general feedback (or guidance) could be appropriate.
- Instances of non-compliance.
- Any emergent areas of interest.
- Any other matters that will help determine how fund update compliance will be monitored in 2018.

This 'stocktake' meets a specific milestone to review quarterly fund updates and engage with the market on our findings. This review forms part of our strategic priorities for 2017-2018 to work with issuers and their professional advisers to improve disclosure documents and offer information.

What we did

We reviewed at least one quarterly fund update from each licensed MIS manager required to produce these particular disclosure documents. This ensured that the practices of all MIS managers were covered. While we carried out the stocktake with an open mind, there were limits to the scope of the review. Five topics were of particular interest to us:

- Fund update availability and accessibility – are fund updates prominently available on issuer websites; do additional non-prescribed disclosures compete for attention?
- Returns – is the comparative market index disclosed, how well is it described and does it take into account imputation credits?
- Investment mix – how common and clearly disclosed is the 'other' investment category, how common and comprehensive is the hedging statement?
- Fund charges – are charges higher in the fund update than in the PDS, is GST an additional charge and is this made clear, do performance fees feature?
- Ease of reading.

[1] See regulation 5(3) of the FMC Regulations for the definition of "publically available", regulation 56 of the FMC Regulations for the general duty to make fund updates publically available, and Part 4 of Schedule 4 of the FMC Regulations for the prescribed format of fund updates.

Key findings

Overall

MIS managers are complying with the general obligation to produce fund updates. Most fund updates did not raise significant concerns.

The review did find some instances of potential non-compliance or instances where disclosure could be improved; in particular issues concerning the prominence and availability of fund updates. These issues are discussed further below.

Fund update availability

In our review of the availability and prominence of fund updates, we found the following:

- MIS managers are complying with the general obligation to produce fund updates.
- A few fund updates could not be found on the MIS manager's website. Others were not sufficiently prominent to help investors find the information.
- Around a third of MIS managers used significant additional non-prescribed disclosures, such as fact sheets, on their websites. These factsheets may include information on fees or returns in a way that is not comparable with the required fund update information, which may be confusing for investors. When these fact-sheets were available, the required fund updates were more likely to be less prominent.

Comment

We are concerned about the findings relating to how available and how prominent fund updates are. It is crucial to ensure that fund updates are easy to find on an issuer's website. There is no point in improving the content of fund updates if investors are not reading them, which may be more likely to be the case if fund updates are not prominent on an issuer's website. Determining if a fund update is sufficiently prominent is a matter of judgement; we do not see this as particularly difficult, as there is a comprehensive definition of '**publicly available**' in the FMC Regulations. We have a clear expectation that MIS managers get this right.

While the use of 'fact sheets' and other such alternative information is not unlawful, it would be useful to examine more deeply the reasons issuers are producing them and how frequently they are used. Further consideration may be given to how returns or fees information is displayed in alternate documents, as it may not be comparable or consistent. Attention may also be drawn away from fund updates by the prominence of alternative forms of disclosure. We will be examining this issue at a future date.

See Appendix 1 for more detail on our fund update availability findings.

Next Steps:

- Follow up and request compliance in all instances where fund updates are not available on issuers' websites, or are not sufficiently prominent.
- Carry out further work to understand why some statutory information is less prominent than others.

- Undertake further review of the content of non-prescribed information, focusing initially on MIS manager websites.
- Produce guidance to set principles ensuring that overall investors receive an appropriate balance of statutory and non-statutory information.

Returns

Benchmark returns information was inconsistently reported across the quarterly fund updates, particularly in the following areas:

- 53% of MIS managers chose not to identify the relevant benchmark market index in the fund update.
- In many instances issuers using an NZ equity index did not make it clear whether they took into account imputation credits in fund updates (or on the Disclose Register).

Comment

We focused on the presentation of indices in terms of whether an investor would easily be able to understand what the index was meant to represent and what adjustments had been applied to the index. As noted above, this was not clear in over half of the funds we reviewed.

At this point, we have not considered in any detail whether the benchmark indices used by MIS issuers were correct or appropriate for the type of fund as a matter of fact or substance.

There is no settled market position on either the inclusion of imputation credits in market index returns, or the disclosure of the market index used in the fund update. Therefore, clear disclosure of the approach taken is important. A small number of instances where after tax returns were higher than before tax returns were noted. While no major issues were noted with risk indicator disclosures, these were not systematically reviewed.

While not specifically reviewing for this issue, it was noted that a number of non-compliant market indices were being used by fund managers. This was not surprising given on-going discussions between FMA and industry, in relation to certain issues that industry is having with compliance and the development of an exemption to resolve some of those issues.

See Appendix 2 for more detail on our returns and benchmark market index findings.

Next Steps:

We propose to advocate for:

- Improved disclosure of indices used in fund updates (e.g. identify what document on the Disclose Register contains further information on the indices).
- Better detail on the offer register, including:
  - ensuring information on the market index for each fund is grouped together in a clear and comprehensive format;
  - clearly disclosing the full name of the relevant indices and the type of index (e.g. total return);
  - if hedging has been assumed or not, if imputation credits have been incorporated, and any other relevant adjustments made; and

- the date the indices became the market indices for the relevant fund (if since fund inception this could be noted).

Investment mix

The use and content of hedging statements varied. Some MIS managers did not produce a statement, some made it easy to determine the level of hedging and others were vague.

When describing the investment mix of a fund, some MIS managers used the term 'other' investment class in a significant way (a share of investment mix of over 5% of NAV). In fund updates, where significant use of the 'other' investment class did feature, it was not always clear what investment types the 'other' class included. Where use of the 'other' investment class features, all fund updates included a further description of what the investment class may include, though the quality of the additional description varied.

Comment

We remind issuers that:

- A hedging statement is not optional - if a fund is materially invested in non-NZD denominated assets, then we consider the extent of hedging to be material information, and expect a hedging statement to be included.
- MIS managers should ensure that the exposure to unhedged foreign currency denominated investments (as a percentage of NAV at quarter end) is clearly described. This should include stating the extent of hedging as at quarter end and could include a brief comment on the hedging policy. Including actual vs. target hedging at a fund level and also potentially at an investment class level should be considered.

What is meant by the 'other' category should be conveyed in a clear, concise and effective way. See Appendix 3 for more detail on our investment mix findings.

Next steps

We expect to see improvements on these issues going forwards.

Fund charges

A key focus on our review here was the way GST is treated, the difference between the fund update and the PDS in terms of a fund charges figure, and any obvious issues to note. The majority of fund updates reviewed did not report fund charges significantly higher than in the PDS. However, 17% of MIS managers had a fund update reviewed where fund charges were materially higher (+ 0.15%) than in the PDS, or 9% after excluding funds where the PDS was subsequently updated.

Fund charges were not specified as inclusive or exclusive of GST in almost all fund updates.

Comment

- We advise issuers of the following in relation to disclosure of GST on fund charges: As a minimum, fund updates should clearly disclose if GST is additional to the quoted fund charges.

- Best practice would be for all fund charges to be quoted inclusive of any GST. However due to the lack of clarity in the law on this issue, and the wide impact (not just fund updates but PDS, advertisements etc.) the FMA is not in a position to require a particular approach. This issue needs further consideration.

  Our assumption is that, in most instances, the difference between charges as indicated in the PDS versus the quarterly fund updates can be explained by the fact that in a fund update the fund charges are actual charges for the most recent scheme year. For a PDS, fund charges should be based on actual fixed amounts to be charged, or where not fixed, best estimates made on the basis of reasonable assumptions about the ongoing level of fees and costs expected to be charged (taking into account actual fund charges for the most recent scheme year), including for performance-based fees. However, we may research this issue further.

See Appendix 4 for more detail on our fund charges findings.

Next steps

We intend to undertake further work to confirm our view as to why there are material differences between charges stated in the PDS and charges in the quarterly fund updates. As noted above, it is our preliminary view that where there are material differences, this is often driven by the way the legislation requires fees to be estimated in the PDS versus the actual historic nature of fees in quarterly fund updates. We are conscious of the potential for bad conduct in this area, hence the need to test our preliminary view with further work. We note that in around half the cases when the actual historic fees appeared materially higher than the PDS estimates, the PDS estimate was subsequently updated.

Ease of reading

Quarterly fund updates follow a standard format designed to make it easy to compare funds, and easy for a non-expert investor to understand. We noted some minor issues with how easy some fund updates were to read.

Comment

- Issuers should consider if wording is clear, concise and effective and consider minimising the use of jargon / technical terms.
- Consider the layout of the fund update to ensure it is easily readable (for example target and actual investment mix on same page, preferably side by side in the same format).

See Appendix 5 for more detail on our ease of reading findings

Next steps

The FMA will review this issue again at the next fund update stock take.

Appendix 1 – Fund update availability

Context

Under legislation (FMC Regulations), MIS managers must ensure fund updates are made publicly available within 20 working days of quarter end (Regulation 56). **Publicly available** is defined in the FMC Regulations, which essentially means that they must be available on the issuers' website in a relatively prominent way.

Some issuers provide additional information on their website such as monthly fact-sheets or tables showing returns or fund charges. This information needs to comply with Part 2 Fair Dealing requirements of the FMC Act (and advertising requirements, if applicable) but the format and content of the information is up to the issuer. There is the potential for such information to show returns quite differently and for such information to be more prominent than the required fund updates. Such information could be confusing, and could dominate investor attention and detract from or obscure the required fund update disclosure.

Findings

Fund update availability

- In all funds reviewed, the manager had produced and lodged quarterly fund updates on the Disclose Register in line with their obligations. However, no comprehensive check of each fund was completed.
- We found fund updates were prominently available on most websites reviewed (64%). In a quarter of cases, they were not prominent, or other information was more prominent (26%). In a small minority, we could not find updates after a reasonable look (10%).

Additional disclosure

When we examined issuer websites for the use of additional / non-prescribed information covering topics such as returns or fund charges, in approximately 40% of cases we found nothing of note. In over a third of cases, we found significant use of additional information, usually factsheets. 26% of cases had relatively minor use of additional information.

(*Note: We have not comprehensively analysed the content of fact sheets. However, fund managers that made significant use of additional disclosure were on average more likely to have their fund update noted as not prominent.)*

Appendix 2 – Returns including the benchmark market index

Context

Legislation states that fund updates must include information on fund returns, benchmarked against an appropriate market index. It must include a brief description of the market indices used, and fund returns must be reported after fees, and both before and after tax. The latest risk indicator for the fund determined from the past five years returns must also be provided.

Findings

We examined how indices had been presented. MIS managers decide what an appropriate market index is (recent research suggests this has been a struggle for some). For this stocktake we did not aim to form a view as to whether the manager's choice of index was appropriate, instead we simply focused on how it was presented.

Benchmark market indices

• Clearly disclosed in fund update	22	47%
• Not in fund update but disclosed elsewhere	23	49%
• Not found	2	4%

Of the funds that did not provide the benchmark market index, most included them elsewhere on the Disclose Register (the majority (17) in the Statement of Investment Policy and Objectives (SIPO)).

Market indices compliance

While we did not focus on the substance of the indices used, we noted that at least 13 MIS managers have potential market index compliance issues. Potential issues included the use of non-compliant measures such as CPI, and the use of inappropriate indices for a fund's investment mix (such as a bond index for property and alternative assets).

At least one case where the investment mix was not appropriately disclosed was noted, which made it difficult to determine if the market indices used are appropriate.

The managed fund industry and the FMA are currently in discussions about market index obligations. A consultation paper was published last year and can be found on the FMA website. The FMA expects to publish an exemption in due course that will resolve most of these issues.

This explains most, but not all of the instances of non-compliance. Following the publication of the exemption, we do not expect to see ongoing compliance issues.

Do market indices take imputation credits into account?

Of the MIS managers that used NZ equity market indices, it was evenly split between those who did or did not include imputation credits. However, for the majority of MIS managers it was either not made clear in the relevant disclosures (generally the SIPO or OMI documents) or not relevant as no NZ equity market index was used.

After tax returns vs. before tax returns

Fund returns must be reported after fees, and both before and after tax. The market index returns must be reported before any fees or tax. There were three instances noted where fund returns after tax were higher than before tax returns. However, this may be a fund-specific issue.

Appendix 3 – Investment mix

Context

MIS Managers must provide the investment mix in a fund update by specifying the percentage of the fund's investments that belong to different asset categories. These asset categories are:

Cash and cash equivalents	New Zealand fixed interest
International fixed interest	Australasian equities
International equities	Listed property
Unlisted property	Commodities

If an MIS manager determines that none of the above applies to a particular investment, then an asset category of 'other' can be selected. The use of this category was a focus of our review, given its vagueness. The 'other' category must be accompanied by an explanation of the nature of the assets included in that category.

A fund update must also show the extent of currency hedging, if it is relevant for the specified fund. This area is of interest as the open wording in the legislation may be interpreted very differently.

The target investment mix of a fund must be disclosed after the actual investment mix. The extent to which there is a difference between targets vs. actual investment was not focused on in the review. Fund updates are not required to disclose how leveraged a fund is, so this topic has not been assessed.

Findings

Use of 'other' investment class

Did the 'other' investment class feature significantly in the investment mix?

Does not feature significantly (under 5%)	37	79%
Features significantly (5% to 20%)	7	15%
Features very significantly (21% to 50%)	3	6%

Of the three fund updates where the 'other' investment class featured very significantly, the fund update included the following descriptions of the investment class:

- may include swaps and currency contracts
- 'Other' includes underlying investments called 'Global Diversified Strategies'. These utilise a different mix of asset classes and strategies. They trade in equities, currencies, metals, energies, agriculture and a range of fixed interest securities. Global Diversified Strategies are used to further diversify the portfolios.
- Other includes foreign currency, which comprises active currency positions implemented by either holding non-NZD cash or foreign currency derivatives, and alternative securities (investment in hedge funds).

Hedging statement

We reviewed if a hedging statement was included, and if so, what it entailed. The findings were as follows:

Statement included – with percentages	11	23%
Statement included - satisfactory	8	17%
Statement included – vague	12	26%
No statement included	16	34%

Some of the statements we decided were satisfactory included comments such as “foreign currency exposure is not currently hedged” (effectively offering an actual percentage, though an investor would need to consider which percentage of assets are in foreign currency so even such ‘satisfactory’ statements could be improved). Other statements offered a target percentage or range which was sometimes noted as being on a net of tax basis.

We note that the actual figure may vary from target due to the MIS manager taking a view. Some statements were vague, stating that hedging was actively managed but that it is not the intention to 100% hedge at all times. Of the fund updates that did not include a hedging statement, no analysis has been done on whether they have foreign currency exposure or not.

Appendix 4 – Fund charges

The FMC Regulations prescribe how fund charges must be calculated and disclosed. However, some areas raise disclosure risks, so we briefly explored these from a fund update perspective. This includes the potential for fund charges to be significantly higher than PDS estimates, the disclosure of fund charges in a GST-exclusive manner, and the structure and level of performance fees.

Findings

Fund charges in fund update vs. PDS

The stocktake examined if fund charges were significantly higher in the fund update, compared to the PDS:

• Fund charges significantly higher	8	17%
• Fund charges not significantly higher	36	77%

In instances where fund charges were significantly higher (+0.15%) in the fund update, the magnitude of difference was usually between 0.15% to 0.20%. In re-examining these cases, in many instances the fund manager had already replaced the PDS with an adjusted fund charges figure, or the issue was clearly due to underlying performance fees being higher than average. This leaves four funds that continue to have a significant difference in fund charges in their PDS vs. actual charges. The FMA intends to undertake further work in this area.

Small selections of other fee issues were noted, including:

- One instance where comparing the fund update to the PDS made it obvious that the PDS did not adequately disclose that the fee in question was an estimate.
- One instance where the performance fee was noted as 0%, even though no performance fee existed.
- One other instance where PDS fee disclosure requires improvement.

Fund update GST disclosure

We examined if it is clear in the fund update if fund charges are GST exclusive or inclusive:

• Clear in the fund update	2	4%
• No, but clear in the PDS	36	77%
• Not clear in fund update or PDS	9	19%

Fund charges GST inclusive or not

We reviewed if the fund charges disclosed were inclusive or exclusive of GST (considering fund updates first, then the PDS, and potentially other documents):

• Exclusive of GST	30	64%
• Inclusive of GST	8	17%
• Mix	1	2%
• Not clear	8	17%

Performance fees

We briefly analysed if performance fees were charged and found 11 instances where they were charged. While a full analysis of all funds a MIS manager offers was not completed, at least four of these 11 instances had 'high risk' features such as high water mark resets or a hurdle rate of return of nil.

We did not specifically compare the performance fee estimate in the PDS to the actual in the fund update. The FMA will consider investigating the assumptions for PDS estimates in the future, particularly if the hurdle rate of return is below the relevant market index.

Appendix 5 – Ease of reading

Context

Quarterly fund updates follow a prescribed format designed to make it easy to compare funds, and hopefully easy for a non-expert investor to understand. Our review considered various factors such as font size, layout, prominence of key points, use of footnotes, and ease of reading in each fund update.

Findings

Investment mix

Fund updates must show the actual investment mix and the target investment mix of the fund which can then be compared. How easily they can be read and compared can be used as a proxy for how much consideration a MIS manager has given the readability of a fund update. We found 15 instances (32%) where the fund update had issues with comparability. Areas where readability may suffer include:

- The actual investment mix is on a different page to target investment mix.
- Different formats are used, making comparisons more difficult. The FMC regulations require the actual investment mix to be disclosed in pie graph format, but the target investment mix can be shown as either a table or pie graph.
- The graph, table, or percentages are difficult to read (for example when the colours of the pie graph do not easily match up with the investment categories).

General ease of reading

We noted 17 minor issues with ease of reading - 36% of MIS managers. One common issue noted was the use of numerous footnotes at the end of a fund update. Although this is the prescribed area for them, best practice would be for them to be clear and concise. There were a handful of instances noted where pie graphs were in 3D format which is not recommended.