Revitalising asset management

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ARTICLE (January 19 2010): Asset management is a business of trust. And trust is the precondition for prosperity and economic well being of the industry. Unfortunately, the liquidity crisis of September 2008 created a gaping trust deficit from which the industry is still recovering. The crisis saw the Stock Exchange impose a floor for over hundred days.

Asset managers in turn due to lack of price discovery, resulting in drying up of the trading volume, suspended dealing in equity funds. The market finally removed the floor on December 15, 2008 though it took another fortnight, due to circuit rules, for the price to reach a level for buyers and sellers to actively trade. Subsequent to suspension of dealing in equity funds, nervous investors redeemed their holdings from debt funds.

And to top it all, in order to stop the hemorrhaging of redemptions, an arbitrary knock-down in Term Finance Certificate prices was imposed by Securities and Exchange Commission of Pakistan (SECP).

This debacle resulted in an alarming drop in assets under management (AUM) and more seriously, investors lost confidence in asset managers, intermediaries and the regulator. From a high of Rs 391 billion in April 2008, the industry AUM reached a low of Rs 177 billion in January 2009. As of November 2009, AUM has recovered slightly to Rs 235 billion.

This is, therefore, a time of introspection for the industry. All stakeholders now must play a decisive role in winning back investors' trust. Mutual funds play an integral role in the world of finance, a force that has powered middle class growth, provided depth to capital markets and added dynamism to the economy. Without necessary reforms, not only the industry but the economy at large will suffer.

A long time ago Adam Smith warned that managers of other people's money rarely watch over it with the same vigilance with which they watch over their own. Negligence and excess, in pursuit of high returns, have hurt the asset management industry the world over. This ought to serve as a warning to the local fund managers.

Investment schemes must be managed in accordance with the fundamental investment objectives and investment policies stated in the offering documents. Moreover, fund managers must make their investment decisions solely in the interest of unit-holders. Investment in speculative, illiquid stocks must be avoided. Such investments may help generate high returns in the short term but it is no recipe for building a consistent, stable and predicable long-term track record.

Prudence demands investment in a diversified portfolio of fundamentally sound, liquid stocks weighted by their market capitalisation. This is the only way to win back investor trust. Keynes defined investment as "forecasting the prospective yield of an asset over its entire life." He defined speculation as "the activity of forecasting the market."

One must, therefore, eschew the folly of short term speculation and espouse the wisdom of long term investing. Daily swings in market returns have no correlation with the long term accrual of investment values. Wise investors realise that when it comes to meeting long term goals time in the market, beats market timing. Our market needs investors who hold in high esteem the traditional values of prudence, stability and soundness.

Furthermore, asset managers must ensure disclosure requirements are timely, clear and relevant. This will ensure unit-holders receive adequate and accurate information about investment policy, ratio of expenses, portfolio details and provisioning details of bad debts, if any. In a foolhardy endeavour to grow assets under management, material information is often misrepresented by stating fund performance in a manner to exaggerate returns.

Omitting material information essential for making an informed investment decision is also a common occurrence. In this connection, it is important to note that Mutual Fund Association of Pakistan (MUFAP) has standardised the Fund Managers' Report and it is now expected that all Fund Managers will follow the format. MUFAP is also developing software to calculate on daily basis the return of each mutual fund.

The returns will be made available on MUFAP website. The objectives of these two measures are to ensure transparency and reliability of information. Asset managers must behold the strictest professional values rather than succumb to the temptation of irresponsible marketing and salesmanship. Ironically, rapid asset growth resulted in compromising investment decisions.

Several asset managers, sitting on too much cash, invested in low grade Term Finance Certificates and second tier stocks. Further, the dangerous trend of back to back transactions, whereby big ticket bank investments were ploughed back into the same banks in shape of deposits came to a head during the liquidity crisis.

The industry should move towards promulgating a Code of Ethics, signed by all asset managers, as a pledge to observe highest standards of integrity and fairness in all dealings with investors, issuers, distributors and regulator. Furthermore, adapting the Global Investment Performance Standards (GIPS) to ensure fair representation and full disclosure will help enhance investor confidence in making an informed investment decision.

GIPS compliant firms voluntarily go beyond legal reporting requirements to demonstrate a commitment to openness and ethical practices by eliminating misrepresentations and omissions of historical data. Intermediaries play an important role in providing investors with true, accurate and timely information on the merits of funds they market.

Too often, however, funds are recommended on revenue sharing arrangements that create incentives to favour some funds over others inappropriately. These compensation arrangements encourage intermediaries to sell certain funds to maximise their compensation rather than to best meet their customers' needs.

Intermediaries that put their profit motives ahead of their fiduciary responsibility as investment advisers hurt their clients in the long term. Funds are also recommended simply on the basis of returns and personal relationships. Returns are important but must always be seen in conjunction with asset quality of the fund portfolio.

Too often intermediaries churn funds from one fund manager to another based on short term underperformance. Moreover, they often urge asset managers to launch new funds based on marketing considerations rather than investment merit. Intermediaries ought to be tightly regulated by SECP and fee sharing arrangements need to be standardised across the board.

There should be mandatory disclosure to investors of the existence of revenue sharing, differential compensation and the potential conflicts that these payments may present. SECP is in need of capacity building. Sustainable framework of rules and regulations are required. Work needs to be done on several fronts including strictly prohibiting fund managers from investing in their associated concerns.

In Pakistan, this practice has allowed some fund managers to make strategic investments in companies in an endeavour to accumulate enough shares for board directorship or even management control. This practice is prohibited world-wide. Moreover, investor's education is painfully slow and no private sector company has the capacity to carry out the task of creating public awareness singularly.

MUFAP must work with SECP to initiate public awareness campaigns to promote the virtues of saving and prudent investment. A targeted advertising campaign on the SECP platform highlighting the various available avenues of investment will also help. A pool of funds borne from the fees MUFAP and SECP charge asset management companies annually should be dedicated to initiating a public awareness campaign.

The virtues of frugality - by promoting a culture of saving - need to be engrained in our society. A major structural reform SECP must undertake is to overhaul the archaic laws governing the post employment benefits schemes managed by employers. The rules pertaining to post employment benefits schemes are outdated and require minimal disclosure and transparency. Other than registration with Commissioner Income Tax, the retirement schemes are not regulated.

Uniformity in governing laws will make it simpler to administer and ensure a level playing field with the Voluntary Pension Scheme schemes regulated by SECP under the Voluntary Pension System Rules, 2005. Post employment benefits schemes should also be regulated through separately formulated rules and brought under the supervision of SECP.

Moreover, tax free pre-retirement withdrawals are currently allowed in post employment benefits schemes, such as provident fund. As a result, people mostly withdraw their balance pre-maturely and utilise them before reaching retirement. Hence, it is important to disallow tax free withdrawals on the same lines as VPS so that these schemes are able to achieve their objectives - to provide a source of income after retirement.

In order to do better, one must remember that trust is everything - success depends upon investors' trust in the fund they buy, the intermediary who sells them and the regulator who regulates them. The economic crisis reflected a trust deficit and lack of professional values. But at the end of the day the lessons from the crisis are hardly new. Over 2000 years ago Homer in the Odyssey reminded us that "fair dealing brings more profit in the end."