The **power** of **one**

Rising investment complexity, the need for greater independent oversight and a growing compliance burden characterises today's super landscape. HARVEY KALMAN reveals why funds are turning to the fund-of-one structure for answers.

It's early 2016 and, amid volatile market conditions, a large superannuation fund makes a brave move: it awards a $100 million mandate to an emerging markets manager.

But this isn't a typical mandate. The fund and manager are sharing data under a unique structure and, when they identify their preferred buy signal, move immediately. The fund grows more comfortable and boosts its allocation.

Within four months, the mandate passes $1.5 billion.

Welcome to the world of the 'fund-of-one' where super funds are creating bespoke portfolios with their managers to reduce risk and simplify reporting.

These are just some of the benefits which have been driving institutional investors to boost their investments in fund-of-one structures over the past six years.

BUILDING THE HOME BASE: SUPPORT FOR THE FUND-OF-ONE

Australia is home to 16 of the largest 300 funds in the world, according to a 2015 survey by (Willis) Towers Watson and Pensions & Investments.

With this size comes enormous economies of scale. Funds are using it to exert more control as they increasingly turn to offshore investments to boost returns while adding new alternative strategies to diversify their portfolios.

It represents an opportunity but one that is also accompanied by greater complexity and risk. Funds can structure their investments to manage this in multiple ways.

One is to ensure their offshore investments are domiciled in Australia, which offers economies of scale and diversification of risk. It allows super funds to collectively benefit from the investment expertise of a fund manager while also enjoying the relative simplicity of Australian tax, compliance and reporting standards.

For example, the reporting requirements of offshore investments housed in an Australian-domiciled fund are automatically aligned with our 30 June fiscal year and must meet the standards of local regulators such as APRA and ASIC. Compliance requirements clearly fall under Australia's well-respected rule of law rather than a range of offshore jurisdictions.

An Australian-domicile ultimately improves back office functioning – efficiencies which can flow into return-generating investment decisions.

An emerging market investment housed in an Australian-domiciled fund for example, can immediately include sub-accounts for regions where it can take months of bureaucracy to be approved as a foreign investor, such as India or Taiwan. Once those sub-accounts are set up, the manager can quickly move on potential investments in those regions while the investor continues to benefit from seamless reporting and a single unit price.

A COMMINGLED FUND VERSUS THE FUND-OF-ONE

The benefits of an Australian-domicile can be obtained in a commingled fund, where an investor's assets are pooled alongside other investors. However, a fund-of-one—where a single investor invests in and controls the fund through an investor registered (or unregistered) vehicle—improves the risk-return dynamics again.

This is because a super fund using a fund-of-one naturally has more power to negotiate investment terms and create a bespoke portfolio with their chosen fund manager across areas such as fees, investment flexibility, transparency and reporting standards.

The sole investor can negotiate investment terms with the fund manager rather than accept 'middle-of-the-road' mandate terms in a commingled fund which are designed to suit a range of investors.

Funds can negotiate lower fees dependent on the size of the deal (typical fund-of-ones range in size from $50–$200 million although a number are greater than $1 billion). Particular assets or investment strategies, such as the use of gearing or derivatives, can be easily segregated from the fund manager's wider offering.

In this way, the structure quarantines and reduces risk, while delivering better reporting and transparency about the underlying investment strategy. The fund-of-one's independent trustee acts as an additional safeguard, monitoring the custodian, administrator, auditors and fund manager.

The risk management benefits of the fund-of-one structure can also flow into its ability to deliver potentially higher net returns.

For example, the investor and fund manager can work together more closely on investment decisions – as the emerging markets manager and super fund mentioned above chose to do so.

Importantly, the investor owns the fund-of-one. If an investor in a commingled fund is unhappy with its performance, the fund must sell its units and reinvest elsewhere, potentially triggering capital gains tax. By way of contrast, an investor in a fund-of-one can add or subtract fund managers from the structure and avoid those potential tax implications.

ALTERNATIVES, EMERGING MARKETS, FIXED INTEREST AND EVERYTHING IN BETWEEN

The fund-of-one structure is growing in popularity as institutional investors continue to diversify their portfolios with offshore and alternative investments.

Investors creating a fund-of-one structure can benefit from improved transparency about complex investments such as underlying hedge fund, infrastructure, private equity, fund-of-funds and long-short funds. The structure can also house more traditional assets such as property, construction, global equities and fixed income.

These types of more complex portfolios featuring a breadth of strategies are becoming par for the course as super funds seek out new ways to generate returns in a low-inflation environment.

Over the past decade, the average Australian super fund has approximately doubled its allocation to alternative assets from between 5–6 per cent to 10–11 per cent, according to a recent analysis by Frontier Advisors. Many funds are also increasingly heading offshore as their size makes it difficult to find attractive local investments in a relatively small local market.

Equity Trustees recently worked with a super fund to create a fund-of-one structure to hold a complex fixed income mandate, which was seeded with $100 million. Over six months, the fund grew to $800 million and has the capacity to reach $2 billion over two years.

GREATER CONTROL WITHOUT BLURRING THE LINES

As institutional investors grow in size, so too does their power to tailor their portfolios.

One of the strongest recent trends has been the move to insource a wide range of funds management activities, which allows funds to create bespoke portfolios on their own terms while minimising costs.

However, insourcing also presents challenges. A recent survey of funds by the Centre for International Finance and Regulation raised issues such as difficulty in attracting top-shelf investment professionals with lower remuneration and the danger of being 'captured' by underperforming internal investment teams.

While a fund manager or super fund can act as trustee of its own fund-of-one, a fund-of-one overseen by an independent trustee presents an alternative option which can blend the best of both worlds.

It still allows institutional investors to access top-line talent with a fund manager, while exerting greater influence (as the sole investor) to negotiate investment terms, including fees. But an independent trustee acts as an additional safeguard to protect the interests of the investor and, in extreme cases, can remove the fund manager to protect the investor.

Australia is one of the few jurisdictions in the world which allows the same organisation to act as both trustee and investment manager of a fund.

The Financial Services Council's recent report *Australia as a Financial Centre: Seven years on* raised concerns about these 'single responsible entity' provisions and suggested they could be solved by adopting international standards or introducing a new collective investment vehicle with different governance provisions.

In addition, ASIC's 2016 *Culture, conduct and conflicts of interest in vertically integrated funds management industry* review, further highlights the advantage of an independent trustee in the model. SF

Harvey Kalman is executive general manager, corporate trustee services at Equity Trustees.