The New Zealand Herald

Brent Sheather: A wake-up call for directors

By Brent Sheather
9:30 AM Wednesday Nov 14, 2012


Some are unlikely to be going to Carmel Fisher's birthday party this month. Photo / Doug Sherring

Normally the local fund management scene is a pretty cosy affair with no one pointing the finger at anyone else just in case they criticise them back sometime in the future. Other players like stockbrokers are far too scared of losing business to even think of criticizing a big local manager. This comfortable state of affairs took a turn for the worse recently when minor player Elevation Capital objected to the performance of the management and directors of listed closed end fund Marlin Global Limited (MLN). MLN is managed by Carmel Fisher and her crew at Fisher Funds. Elevation is led by Chris "Swashbuckler" Swasbrook and counts amongst its board former fund manager Craig Stobo, who used to run BT Funds Management.

The story thus far is that Elevation has bought a few shares in MLN and then had the temerity to request that MLN put before shareholders a proposal that MLN sell up its share portfolio and pay out the money to shareholders. That would mean the end of the fee stream. Nasty! I think we can safely assume that Craig and Andrew won't be going to Carmel's birthday party in November.

Elevation's case is firstly, that winding up MLN will give shareholders total proceeds considerably higher than the current market value of MLN because the company trades at a discount to Net Asset Value. Secondly Elevation notes that the shareprice performance of MLN hasn't been great because it has underperformed the benchmark however the net asset value has outperformed. Thirdly Elevation says MLN has a very high total expense ratio this has averaged a whopping 2.48 per cent pa since it started.

Not unexpectedly MLN's independent directors rejected the proposal calling it "opportunistic" and "without merit". The question before the panel today is "was this the right decision by the independent directors and did they consider the key variables?" But first, a bit of irony Stobo used to run BT and just last week I looked at the management expense ratios of three of BT's largest funds and, hello, at an average of 2.0 per cent they weren't too dissimilar to MLN's 2.48 per cent that Mr Stobo is criticising. But hey, times change and it is good to see a bit of competition in the fund management space.

Complicating things further the independent directors of MLN have just reappointed Fisher Funds as fund manager for a further 5 years. The Chairman of MLN, Alistair Ryan, said that the Board had taken expert advice from the likes of Morningstar and others in making those decisions and in particular the Board noted that Morningstar had advised that "MLN has been the best performing of twenty nine comparable NZ PIE entities investing internationally since inception".

A cynic would say so what? Previously this column has shown that NZ international PIE funds have very high fees and a tax disadvantage so the comparison should be to the performance of the index and NZ investors can access this performance with very low fees via a number of low cost passive funds listed on various stockmarkets with management fees very much lower than that of MLN. The appropriate comparison is with the Global Smaller Companies Index. Back to school Morningstar!

But past performance is probably irrelevant anyway Marlin has only been going for four years. Warren Buffett has a history of outperforming the stockmarket long term but has underperformed in the last 10 years. Maybe MLN's independent directors are looking in the wrong direction. Writing in the Financial Times the other day a senior visiting fellow of the Pensions Institute at the Cass Business School said "there is little academic evidence to support the argument that asset management and a potential for outperformance is more important than costs" so perhaps MLN's independent directors should instead have focused their deliberations on cost and asked themselves how do total fees of 2.48 per cent pa look relative to competitors including passive funds and most importantly relative to prospective returns.

All going well they would probably have concluded that 2.48 per cent is a very high expense ratio. Fisher Funds have pointed out that their standard management fee is "only 1.25 per cent and under some circumstances can drop to as low as 0.75 per cent". Fisher Funds added that historically the fees charged have been impacted by defending various liquidation proposals. This is correct but the bottom line is that the average fee sustained by shareholders has been 2.48 per cent and one can argue that the only reason shareholders incurred fees to defend the liquidation of the company were because fees were too high in the first place. Furthermore MLN has an indefensible performance fee structure whereby the benchmark is mis-specified it is a fixed interest based benchmark against an equity performance.

It might be a further revelation to MLN's independent directors that all the evidence, not to mention commonsense and economic theory, suggests that the higher the annual fee impost of a listed fund the wider will be the discount, ceteris paribus. A share only has value to the extent that it produces cash flow. But if you own a share portfolio via a managed fund you don't get all that cash flow some of it is siphoned off in fees and all other things being equal a fund will trade at a discount approximating the net present value of the cash flow foregone in fees.

Putting it bluntly you can buy back shares and manufacture an artificially high dividend until the cows come home but if your fees are too high that pesky discount isn't going to go away and that is the story of MLN thus far, unfortunately. Pity none of MLN's advisers are brave enough to tell it like it is! Marlin's independent chairman has pointed out however that sentiment is a factor as regards discounts.

So all in all not a great performance from MLN's independent directors but they are in a difficult situation. Clearly the fact that total fees have been as high as 3.4 per cent since it started and have averaged 2.48 per cent pa is likely to be a huge impediment to performance and this needs to be addressed. Anything else will just mean that the discount will reappear again sooner or later and probably attract the attention of predators. MLN needs to get some new advisers, ditch the performance fee and reduce management fees further. Then the discount, and perhaps predators like Elevation, might go away for good. The vote was put to shareholders early in November and the resolution failed but significantly of the shares that were voted one in four voted for the transaction. This is a wakeup call for directors.

By Brent Sheather