



Fixed interest investment policies - Trustees beware

This article originally appeared in the Asia Pacific Risk Management newsletter. It is reproduced here with the kind permission of Roger Kerr, the Principal of APRM. At the time of writing this article Roger was a Director of Trust Management Limited.

Over the past few years, Asia Pacific Risk Management (APRM) has been involved in reviewing and in some cases advising on client's fixed income portfolios. Some of these funds have been community-based trusts that have transferred management in-house, having previously been managed by external fund managers.

Investment policy criteria lacking

In a number of cases we have been concerned at the lack of detailed and robust investment policy criteria that such funds have had in terms of investment parameters around credit rating limitations, security ranking and market liquidity of the underlying investment securities.

The lack of depth in the New Zealand capital markets makes for a very difficult balance for fixed interest portfolios to correctly set performance benchmarks that accurately reflect appropriate risk/return considerations.

Unrealistic Statement of Portfolio Objectives

We have observed some quite unrealistic Statement of Portfolio Objectives that significantly weight the risk/reward balance more towards higher risk and less liquid instruments such as subordinated debt, capital notes and perpetual notes as these instruments are often allowable (or not excluded) under the prevailing investment policies.

We have subsequently observed that many of these investment portfolios ultimately contain highly illiquid securities that have become almost unsalable in the current market.

Lack of continued disclosure

Another observation that has deeply concerned us has been the apparent lack of continued disclosure from the external fund manager to the Trustees of the fixed income funds in relation to the fund manager's association with new issues or initial price offerings that are sold into the fund.

We have seen a number of examples of portfolios that contain illiquid instruments dating from original IPO and primary new issue offering that the fund manager's investment banking or broker division took a selling/distribution commission from the issuer and failed to disclose this to the fund management client.

Whilst the New Zealand fixed interest market is very small and there will always be requirements for 'Chinese walls' between the fund manager operations and the capital market originations operations within the financial intermediaries firm, we believe that this disclosure is in the best interests of the fund manager, otherwise they may unfairly be accused of dumping 'junk bonds' into their fund management clients' portfolios, whilst obtaining pecuniary advantage for doing so.



Trustees need to be vigilant and realistic

APRM's Treasury Broadsheet dated 31st August 2012 recommend that Trustees of community and private investment funds need to be more vigilant in the determination of fixed interest investment policy parameters and also more realistic in terms of their expectations around the performance benchmarking of such funds.

For example, rather than straight-jacketing the fund manager with expectations based on pre-determined target yield returns, they should apply the industry accepted practice of using NZX government and corporate bond benchmark indices.
