FINANSTILSYNET
THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

Thematic inspection balanced funds

Summary of a thematic inspection of balanced funds

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1 Background

Given the low level of interest rates in recent years it has been challenging to achieve return based on a desired risk profile. Many investors have opted for funds that combine exposure to both the fixed income market and the equity market. Since the start of 2013 assets managed in Norwegian balanced funds have risen by more than 170 per cent, and now stand at NOK 57 billion.

As part of its ongoing supervision of securities funds, Finanstilsynet has in 2015 and 2016 analysed a total of 47 Norwegian balanced funds that offer exposure to both the equity market and the fixed income market[1]. Given the large increase in new subscriptions to balanced funds, Finanstilsynet decided to take a closer look at these funds, in particular their cost level and their use of rebalancing and benchmarks.

This report presents the observations and assessments resulting from Finanstilsynet's thematic inspection.

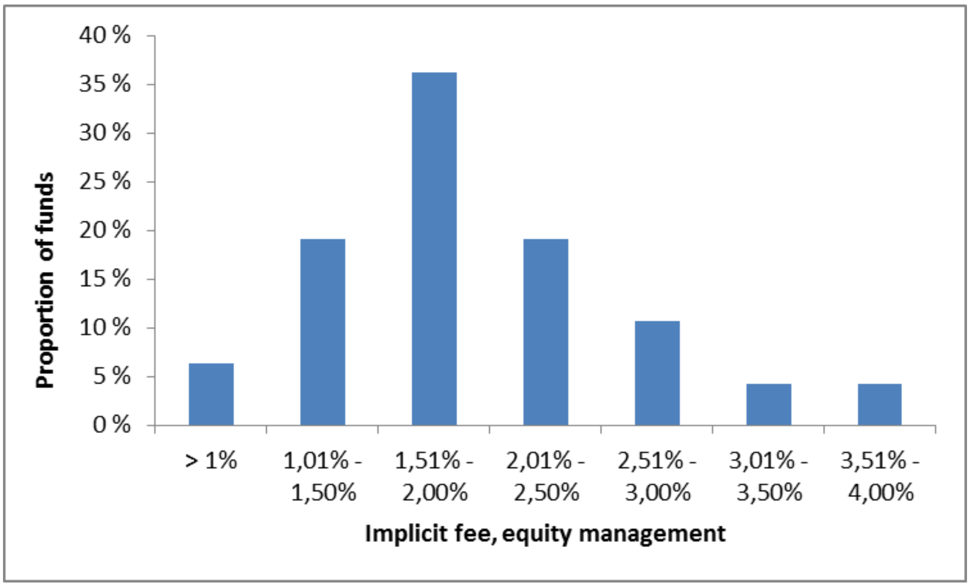
2 Level of fees

Finanstilsynet has analysed the management fees charged by balanced funds. Management fees at actively managed equity funds are normally considerably higher than at pure fixed income funds since equity funds require a higher degree of analysis capacity and are thus more cost-intensive to manage. A balanced fund with a large equity component may therefore justify a higher management fee than a balanced fund with a small equity component.

To enable comparison of management fees across balanced funds with different equity components, Finanstilsynet has calculated the share of the fee accruing to equity management based on the assumption of a prevailing market price of 0.5% p.a. for managing funds in fixed income securities. This level is in the upper half of the scale for pure fixed income funds in the Norwegian market. The remainder of the management fee is assigned to equity management (implicit fee), and is distributed based on the average equity component over the last three years.

[1] 'Balanced fund' means a securities fund that normally has an equity exposure below 80 per cent, its remaining holding being invested in fixed income instruments; see the Norwegian Fund and Asset Management Association's industry standard for information and classification of equity funds and balanced funds.

Chart 1: Estimated price for managing equity securities in balanced funds[2]



The analysis shows that 38% of the balanced funds charge an estimated fee above 2.0% p.a. for managing the equity securities portion. The highest identified fee is 3.8% p.a.

A large proportion of balanced funds are highly priced. Many investors can achieve lower management costs by investing in pure equity funds and pure fixed income funds separately. Rebalancing between equity and fixed income positions in a balanced fund may justify costs somewhat higher than those incurred overall by investing directly in equity securities and fixed income securities respectively. Even so, the current level of fees appears to be high for many funds, particularly in view of the limited use made of the scope available for reallocation; see the next section.

3 Use made of the scope available for reallocation

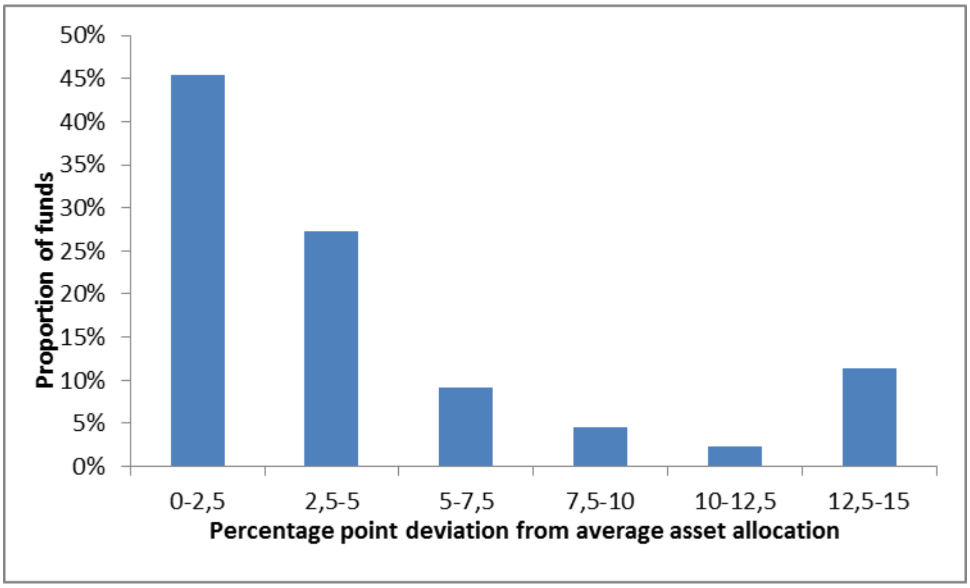
Assets under management at balanced funds are invested in equity securities and interest-bearing securities based on a distribution stipulated in the fund's rules and prospectus. The holding of equity securities and interest-bearing securities will normally vary within a set range. An important characteristic pointed out by vendors of many balanced funds is that the balance between equity securities and interest-bearing securities is subject to continuous review, and that reallocation is performed when this is considered optimal in relation to the manager's market view.

In order to identify the extent to which use is made of the scope available for rebalancing, Finanstilsynet calculated the deviation from the average equity component over the last three years. This was done by ascertaining the average proportion of managed capital invested in equities over a three-year period and then measuring the nominal deviation from this average at each month-end. Finally, the average of the nominal deviations in the period was

[2] All calculations are done using data obtained from Morningstar, August 2016.

calculated. Finanstilsynet opted to measure monthly deviations against the actual level of equities. This was done to allow for the fact that over an extended period a manager may select an equities exposure that deviates from the fund's positioning in a normal situation.[3]

Chart 2: Reallocation at balanced funds, monthly observations against last three-year average



Most balanced funds allow investments in equity securities to vary by 10 to 20 percentage points up or down from the expected equity component. As shown in chart 2, 45 per cent of the funds deviate less than 2.5 percentage points and 73 per cent less than 5 percentage points from the average equity component in the period. This shows that many funds make little use of the opportunity to vary the balance between fixed income and equities investments in line with the manager's market view[4]. Where high pricing of balanced funds is combined with low use of the scope available for rebalancing over time, unit holders in many funds will be better served by investing directly in equity securities and fixed income securities respectively.

4 Separate reporting of equity returns and fixed income returns

In Finanstilsynet's view it would be in the customer's interest if management companies, in addition to reporting overall returns for the fund, also specified the returns on, respectively, equity management and fixed income management measured against the respective benchmarks. Extended reporting of historical returns broken down on fixed income securities and equity securities will improve investors' basis for making informed investment decisions, inter alia by putting them in a better position to evaluate the merits of investing in balanced funds as opposed to investing in separate equity securities and fixed income securities funds.

[3] Finanstilsynet has also analysed use of the investment limit measured against the midpoint of the range defined in the fund's rules. This analysis produces broadly the same results.
[4] A fixed allocation between equities and interest-bearing securities may also be a strategic choice on the part of the manager. Information in prospectuses for most funds in the survey states that the manager continuously reviews the allocation and makes active use of the limit over time.

Management companies should therefore in their periodical reporting to unit holders and in their marketing material specify their returns from fixed income management and equity management respectively.

5 Benchmarks

Many Norwegian balanced funds use Oslo Børs' government bond index as their benchmark for fixed income exposure to the Norwegian market. However, balanced funds' fixed income investments are usually in securities issued by financial institutions and industrial companies, and carry both credit and liquidity risk. Oslo Børs' government bond index will in such case not be a relevant basis for comparison inasmuch as this index has neither credit risk nor illiquidity risk.

Currently no fixed income index covers the credit element for Norwegian fixed income securities. Any fund that makes use of a benchmark that is not relevant must in Finanstilsynet's view ensure that its prospectus, and any other marketing material, contains information to the effect that the fund's benchmark for the fixed income component does not reflect the risk attending the fund's investments. It should be noted that prospectuses must contain the information required in order to enable a well-informed judgement of the fund concerned and of the risk associated with investments in that fund.

6 Choice of underlying funds

Balanced funds are often structured in such a way as to achieve exposure to, respectively, equity securities and fixed income securities through investing in underlying equity and fixed income funds rather than investing directly in individual securities. In recent years fund investors have opted to channel an increasing proportion of their equity fund investments to passively managed index funds or close-to-index equity funds. Since this type of fund is less costly to manage, the management fee is normally far lower than in the case of actively managed funds.

Finanstilsynet notes that only two of the balanced funds avail themselves of index funds to achieve equity exposure. These two funds charge an overall management fee of about 0.3% p.a., which is far lower than in the case of actively managed balanced funds. The current offering of balanced funds is therefore little suited to customers who prefer a passive, more cost-effective exposure both to fixed income securities and equity securities.

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