

## **Introduction**

What are the options for investors today? A unit trust or an individually segregated account with a minimum size of between RM1m to RM2m. There is nothing in between. Thus, the “personal banking” account holders with minimum sizes of RM200,000 and above have only unit trust as an investment vehicle.

What can lead to greater choice and access to talented fund managers for the investor? How can they gain access to fund managers who have different methodologies of investing with superior performance track records?

Co-mingling is the answer.

## **What is co-mingling?**

In the more advanced markets, co-mingling or otherwise known as “pooled” funds or “partnerships” has been recognised as the standard and efficient way of managing a group of portfolios. Portfolios pursuing the same strategy are encouraged to be “pooled” together and managed as one big portfolio. Whatever is bought or sold is for account of this one fund. In effect, co-mingling behaves like an open-ended private unit trust since each portfolio within the group is in effect a member. Co-mingling is just a method for fund managers to organise the management of their funds in the fairest and most efficient manner.

## **Access to talent and Time to Market**

The biggest advantage to co-mingled funds is the speed in which it can be put up or wound down since it is not a legal entity. In a world where investment ideas come and go quickly, managers must have the flexibility to take advantage of ideas that appeal to investors. From ideas to strategy to marketing, co-mingled funds can be organised very quickly. The speed and flexibility to market is the single most important factor in driving innovation in the investment industry on a commercially viable basis since there are very few related costs to setting one up or wounding them down.

It also opens up a middle segment of the market whereby you do not need to have RM2m before top fund managers would manage your funds. This way, investors can gain access to talented fund managers for less.

## **Co-Mingled Funds Versus Unit Trusts**

Whilst unit trusts are legal entities in themselves, co-mingled funds are not. They are just a grouping of investments with the same interest. However, the operational structure of co-mingled funds is very similar to that of a Unit Trust except that where a unit trust issues units to members, co-mingled funds do not

really issue anything. To keep track of who owns what and how much returns are made by each member, co-mingled funds will often create “notional” shares which acts like units. These “notional” shares have a Net Asset Value, which may or may not be available everyday. Redemptions or creations may only be available quarterly. There are no front or back-end loads and no bid-offer spreads; and managers are not allowed to have a manager’s box (i.e. . do not carry any inventories of the fund).

### **Restrictions**

Co-mingled funds are not generally available to the public at large because they do not issue prospectuses and their minimum investments could be high (although smaller than the RM2m minimum for a segregated portfolio). Fund manager’s market specific strategies or objectives instead of funds and once a client agrees to a strategy, the fund manager will put the client into one of these funds. Thus a client can have multiple portfolios all run in a different way through different co-mingled funds. Since co-mingled funds are generally not available to the public at large, they are often regarded as private funds meant for the more sophisticated investor and typically an information memorandum of each fund is all that the investor receives. Because of the relative sophistication of the products and the loose regulation surrounding co-mingled funds, these funds are only permitted to be marketed to sophisticated or “qualified” investors; typically those that have networth above a certain predetermined sum.

### **From Private to Public Funds**

Some of the biggest funds in the world today began life as private co-mingled funds. When a co-mingled fund grows beyond a certain size typically in terms of the number of members more regulation is required. Many co-mingled funds thus transform themselves into mainstream mutual funds or unit trusts and is then marketed nationwide.

### **Towards GIPS**

Global Investment Performance Standards or “GIPS” is a set of performance standard advocated by the Association of Investment Management and Research or “AIMR.” One of the key requirements of performance presentation in these standards is the creation of “Composites,” which is really a collection of portfolios that share similar strategies, benchmarks, constraints or objectives. The standards require that the performance results of each composite be presented and not that of an individual portfolio. This is to ensure that fund management firms do not cherry pick and market their best results (often a single portfolio). Composites therefore provide a fairer and more representative way of performance since it is the average result of all portfolios that share these similarities. Co-mingled funds are essentially composites in themselves since it is a collection of members’ funds that is pursuing the same strategy or objectives.

Rather than individual portfolios in a composite, members' funds are pooled into one big Composite fund and executed in an identical way for every member of the fund. The time weighted return results will be identical for members for any given period and such funds will satisfy the Composite requirement of GIPS.

### **Small Segregated Accounts - Fund Manager's Nightmare**

From a fund manager's point of view, it is a nightmare having to manage 20, 50 or 100 individual portfolios of RM50,000 each with the same strategy. In theory it sounds easy – you can pro-rate all that you buy and sell across all the portfolios and achieve consistency. In practice though, it is not so simple. Even if you have a first class pre-trade compliance system, your post-trade results will disappoint. This is because there will always be some portfolios that will end up buying or selling more or less because of rounding and small portfolios tend to end up with a larger than desired tracking error when benchmarked against the same strategy group as a whole. Now imagine running a group of 50 segregated accounts and on a given day you bought 2 stocks and sell 1 stock for a particular group. How many trades do you need to book out? Yes, 150 trades need to be booked out. Your custody and settlement bank will be very happy indeed as they charge on a per settlement per account basis. The expenses will certainly eat into the returns and again smaller portfolios tend to suffer most because the settlement cost is fixed irrespective of the size bought or sold. The practice of running individual portfolios pursuing same strategies becomes highly inefficient and the dispersion of returns may be too indefensibly wide. Ultimately, investors suffer. What if you co-mingled all the 50 portfolios into one fund? The result is that you need only to book out 3 trades and the cost reduces by a factor of 50!! Fund managers benefit, investors benefit.