NZ Shares Capacity Analysis

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MJW Investments

Introduction

There has been a lot happening in the NZ share fund manager space. We have had the changes at AMP Capital Investors with their outsourcing of the role and appointment of Salt Funds Management to manage $600 million plus. The demise of AMPCI's NZ share team has led to NZ Super taking back their funds and managing them in-house. NZ Super has also decided to take back the funds they had invested with Milford Asset Management given the investigation of Milford by the FMA.

At the same time we have the ongoing in-flow of funds into KiwiSaver schemes with estimates of over $500 million flowing to NZ share managers per annum. We therefore thought it was time to examine the issue of capacity i.e. how much do the fund managers consider they can reasonably manage in their portfolios? The issue of size of funds under management (FUM) can be a factor when selecting a manager: higher FUM implies that the clients like the manager and a smaller FUM implies otherwise.

Participants

We contacted a number of managers to establish their views on the subject and to ask what limits they are operating to. The managers are:

- ANZ Investments
- Devon Funds Management
- Fisher Funds
- Castlepoint Funds Management
- Harbour Asset Management
- Milford Asset Management
- Mint Asset Management
- Nikko Asset Management
- Salt Funds Management

Basic statistics on the NZ market

- NZX50 capitalisation is currently around NZ$65.8 billion. Of this, 40% represents the top six companies. All listed equities amount to $68.6 billion.
- Daily traded volumes: the NZX reported $140m daily average in 2014. However it has been dropping over the current year. In contrast the daily turnover of the ASX200 is a staggering A$4.8 billion, with the ASX having a market capitalisation of A$1.65 trillion.
- The NZX50 includes four companies which are non-NZ domiciled and amount to 4% of the index.
- The current foreign ownership of the NZX amounts to around 43% of the index. This is high compared to the more normal level of around 35% since 2004.

What are the constraints on a manager's capacity?

The NZ market is a relatively small market and liquidity is limited, except for the large stocks which attract global buyers. As a result, when a manager with a large holding decides they want to reduce their holding it can take a few days to sell. This factor means managers may have to limit their FUM. As the success of a manager's business is ultimately going to depend on them producing good steady performance over time, they need to be able to buy and sell stocks when they want to - consistent poor results will see clients exit. Accordingly the manager has to make a business decision in regard to trading off higher FUM (and the resulting higher management fees earned) with the adverse impact that this could have on the manager's performance.

The factors are seen as:

- NZX market free float
- Annualised daily traded volumes
- Manager style (e.g. value, growth, large cap, small cap), and
- Whether the manager runs an NZ listed property fund with significant FUM.

To add to the factors we also have the following issues:

- The manager will have a number of different funds and each will have its own capacity limit.
- The mandate may allow a manager to invest in Australia to some extent.
- The manager will have a maximum position it will want to take in any one stock. Some managers are reluctant to invest in more than 5% of any company due to the market disclosure requirements.
- The manager will have a maximum allocation to cash.

We also need to consider the question of whether we are talking soft or hard close. The former still allows existing investors to put more money into the fund. Talking to some of these issues:

Style This is going to have the largest impact on a fund. Clearly, a small cap focussed fund will have a lower capacity limit. Similarly a manager with a large cap focus with only limited holdings in small caps has a higher capacity limit. A value manager is probably going to have a lower turnover than a growth manager as the factors which a value manager is looking for – e.g. arguably more established businesses – are only going to change slowly. In contrast a growth, and in particular momentum, manager is going to have a much higher turnover and so the ability to liquidate stocks in a timely period is going to limit capacity.

Exposure to Australia The ability of a mandate to invest in the larger Australian market will increase capacity, but with a limit to the amount of Australian exposure, a manager's capacity will still encounter the same issues in the NZ market. To illustrate, if a manager has assessed a NZ capacity limit of $1 billion and a maximum 30% exposure of the Fund to the Australian market, then the total fund size could amount to $1.43 billion.

Property funds The number and size of listed property funds which invest predominantly in the NZ market with only limited Australian exposure is small in number and FUM, with only two with funds exceeding $100 million. As expected, where a manager has a property fund this will limit the total NZ equity capacity of the manager. The maximum that managers said they could invest was variable, ranging from $150 to $600 million.

Impact of KiwiSaver flows

Managers will have different levels of inflows to KiwiSaver Funds. ANZ Investments has a strong regular fund flow while Harbour Asset Management or a Mint Asset Management will be less impacted. One would expect that there are some managers who are going to hit their capacity limits more quickly than others.

Soft and hard close numbers and examples

Most managers quantify capacity in terms of an NZX free-float figure. Naturally, the figures quoted varied and were 2%, 1.2%, 1.5%, 1.6% and 2.25%. So there was a reasonable range with the higher figures associated with the managers who were more focussed on the larger cap companies. All the managers were clear that they still had some capacity before they needed to impose a soft close on the total business. In the case where a manager discussed a hard close, the limit was 30% above the soft close. The limitations in the NZ market have been exposed by certain managers not choosing to tender for several recent large mandates on offer.

Within the above limits there are some concentrated funds with very specific mandates which have a lower limit. In the case of three specific funds for two managers, the fund is already closed to new clients' money.

Strategies to increase a manager's capacity

The only way for an NZ manager to address the constraint on their NZ share capacity is to diversify the portfolios and expand the mandate to allow a greater allocation to Australian shares. Funds have a range of limits varying from 15% to 35% on this exposure level but in most cases the fund is still benchmarked to the NZ index. We are now starting to see a change in benchmark to specifically include an Australian index which will give the manager greater scope to invest away from NZ and thereby increase the manager's capacity. This development almost takes us back to the question of whether a portfolio ought to include separate allocations to NZ and Australian shares and the question of how good the NZ manager is at investing in the Australian market.

ABOUT MELVILLE JESSUP WEAVER

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