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Benefits of investment trust mergers

Nomura Research Institute, Ltd.

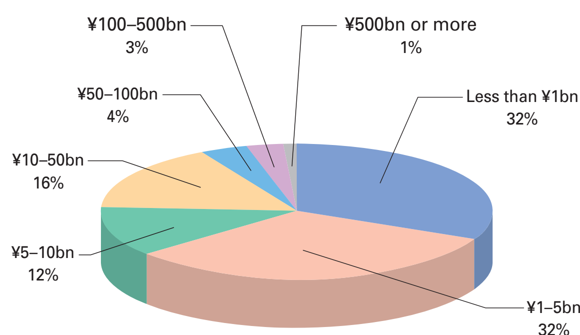
Regulatory changes are expected that will allow Japanese investment trusts to merge starting in the summer of 2007. We anticipate consolidation among small funds and look forward to the adoption of a merger framework that has as its first priority investor interests and not management firm profits.

Changes to allow investment trust mergers

Revisions to the Securities and Exchange Law that became law in June 2006 also made changes to the Investment Trust Law. The revised Investment Trust Law contains a provision for the merger of investment trusts, and we expect fund mergers will be allowed starting in the summer of 2007.[1)]

The consolidation of management firms in recent years has created many cases of management firms having funds with similar or overlapping investment styles[2)] as well as a proliferation of small funds with relatively few assets. This has led to calls for the development of a legal framework for fund mergers. Smaller funds may find that the cost of preparing disclosure documents and hiring a CPA as auditor may exceed their revenues. The Exhibit illustrates the distribution of net outstanding assets in open-end investment trusts at end-October 2006. While generalizations should be avoided because management fees vary from fund to fund, if we assume that a minimum of 1 billion yen in net outstanding assets is required for a fund to cover its expenses, more than 30% of existing investment trusts are unprofitable.

Exhibit. Distribution of outstanding assets at open-end equity investment trusts



Note: Data as of 31 October 2006.

By merging, small funds can capitalize on economies of scale by reducing fund expenses[3)] as a percentage of total net assets (ie, the expense ratio), enabling more stable management. Under the current system, the only option available to funds with dwindling assets under management is to wind up the fund and return capital to investors. This is considered problematic because it means that investors may be forced to redeem shares against their will.[4)]

Conditions for fund mergers

Under the revised Investment Trust Law, funds seeking to merge would have to meet two conditions. First, both funds would have to have the same trust bank as a trustee. The second condition concerns investor approval. Written agreement must be obtained from more than half of all investors and more than two thirds of all voting shares. The first condition is met easily enough; the two funds simply have to hire the same bank to act as their trustee. Nor is the second condition likely to prove a major hurdle in practice, as most funds should be able to satisfy it using the “implied agreement” provision.[5)] In addition, regulators are now studying quantitative and qualitative guidelines for merger candidates, as reckless mergers could impair performance and otherwise harm investor interests.

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Fund mergers in the US

The experience of the United States, which already allows mergers between mutual funds, may serve as a reference point.

Possible catalysts for fund mergers include management firm mergers, management changes at one of the management firms, and periodic fund reviews based on an analysis of profitability. Funds more likely to pursue mergers include those with dwindling assets under management and those sharing similar investment strategies. For example, when Merrill Lynch Investment Managers and BlackRock merged at the end of September 2006, several of their mutual funds also merged. Merger candidates included funds with similar investment styles and past performance.

As a rule, a merger of funds in the US requires the approval of both boards of directors[6)] and investors. Such approval is difficult to obtain unless investment strategies and processes are quite similar. As such, the merger process is said to be easier for bond funds, where there is less variety in investment strategies than at equity funds. However, mergers of passively managed equity funds are usually easy to implement. Another common pattern is of widely diversified funds merging with more focused funds investing in securities already owned by the former, such as a global fund merging with an Asia fund. Incidentally, almost no proposals for fund mergers have been rejected by investors. This is partly because boards generally take the interests of investors into account when proposing mergers and often hire outside specialists to ensure investor support.

Merger-related costs include legal fees, auditing fees, and expenses for the preparation and mailing of disclosure documents to investors. These costs are significant, and it is necessary to decide who will pay for them. Decisions about which of the two funds' past performance records to use and what fees to charge are also important. The track record of the larger or older fund is not always used. Instead, the decision often takes into account which of the two funds has an investment strategy closer to the merged entity, or which fund the new portfolio manager was involved with. As for management fees, nothing need be done if the new fund charges the same fees as the less expensive of the two original funds, but an increase in fees requires that explanations be provided to the fund's board of directors and investors.

Managers should focus on investor needs

Once fund mergers become possible, we expect management firms to do more to consolidate smaller funds and funds with similar investment strategies with the goal of improving efficiency and reducing costs. But if a merger is perceived by investors as being designed to benefit the management firm, there is a risk that they will suddenly redeem their investments, leaving the merged fund with even fewer assets than the two original entities. While this is an extreme example, it serves notice of how important it will be for management firms to avoid compromising the interests of investors and present a strong case for mergers to financial authorities, sales firms, and investors alike.

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Note

1) The Investment Trusts Association, Japan, is seeking tax code revisions to lighten the tax burden of investment trust mergers.

2) For example, Mitsubishi UFJ Asset Management, created by the consolidation of eight separate management firms over time, has seven funds linked to the Nikkei Average as well as three that track the TOPIX.

3) Here, "expenses" include fund manager fees and the cost of preparing disclosure materials.

4) Provisions have been established to ensure that management firms are unable to perform actions clearly not in investors' interests—for example, all proposals must be approved by a majority of investors.

5) A provision in the Investment Trust Law (Article 93) declaring that investors who do not attend the investors' general meeting or cast a vote are assumed to be in agreement with the resolutions proposed at the meeting.

6) This is in the case of company-type investment trusts.

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