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So much has been written about the measurement of funds under management (FUM) and flows into investment products with little explanation about what it means to unit holders and advisers. Simon Solomon, managing director of Plan For Life - the only researcher to report retail inflows and outflows separately - goes on the record with Matthew Smith to talk about the importance of funds flow measurement.

What's the difference between reporting inflows and outflows separately rather than reporting the combination of the two as 'net flows'? Why is the separation important?

Reporting net flows [outflows subtracted from inflows] presents problems because you can often end up with a negative figure that makes it impossible to measure the size of the market.

Inflows show how the market is growing or not growing, and you need both inflows and outflows to consider managers' relative market share ... true market share can't be represented by net flows; I don't know anyone who can do the arithmetic successfully when you have a number of positive and negative net flows, adding up to an overall figure - the absolute figures are important, but the percentages can give rise to very strange anomalies.

Why should advisers care at all about managers' inflows and outflows?

Inflow data is important because it tells a lot about the marketing health of an organisation. Obviously if the inflows are zero, then it's not as healthy as a manager or fund with very substantial inflows; inflows can thus tell a story about the strength of an organisation as a marketing entity.

Outflows on the other hand, demonstrate the manager's ability to retain business; some types of outflow are likely to be outside his control, but others are definitely within his control.

How do you use inflows to make a judgment on a manager?

There are two main ways to measure inflows: from an internal point of view, and from a market share perspective. To find out the rate at which a manager's funds are attracting inflows, take the total FUM figure at the start of a period and divide it into the inflow figure in the period, and you end up with a rate of inflow. From that you can deduce a lot in terms of how the manager's funds shape up in the market. Its inflows and rates of inflow will relate to whether its marketing is hitting the mark, if it's getting support from advisers, if it's performing in terms of attracting new business. The analyst can make some assumptions by working off the concept that generally, growth in inflows is good - it's a simple concept, based on the premise that a small fund is progressing if it's growing - it's not as important for medium size funds to be growing at a frenetic rate, and the same with large funds, but you do want large managers to have some consistency of inflows quarter by quarter.

What about ways in which managers can make their flows look better than they actually are?

If a manager transfers funds out of an old fund into a new fund,

it can make the flows into the new fund look better. To avoid this, when we prepare our data, we endeavour to strip out the transferred funds. Usually if you have a manager that has an old fund and it is finding the administration of the fund too onerous, they may transfer the moneys into a new you-beaut fund and the new product appears to have great flows for a while and from the fund managers point of view it looks great. But in actuality it's not new money, so we try to eliminate that; what you should be left with is a measure of inflow approximately equal to the manager's gross sales; basically how much new business a manager is getting.

Do you find managers that transfer funds into new products just to make their flows appear better?

There were managers that appeared to do that in the past but this has declined because the industry is much more transparent. We now find that quite a number of funds report inflows net of transfers; if they have the intention of eventually closing a fund they will put out a circular announcing fund closures. These days, the major analysts who access our data do their own follow-ups to ensure they understand what is contained in inflows.

What about outflows? What does it tell you about a manager who is reporting outflows?

The outflow figure measures the loss of funds. There are a number of possible reasons for this. You might have a super fund that people are taking money out of because they are getting to retirement age and you would expect redemptions resulting in outflows. But the other reason for outflows could be if advisers or investors lose faith in the manager, which can result in accelerated outflows. That can be a result of poor administration or poor performance. The reasons for accelerated outflow may not be immediately obvious, but if you do the same calculation as the inflow rate and you find that the manager went from, say a 5 per cent outflow rate to a 10 per cent outflow rate over two quarters, then you have to ask why.

An outflow isn't likely to be a leading indicator to poor performance is it?

You can't tell without asking more questions. Analysts look at these figures and examine trends that emerge. If a manager has strong outflows, the analysts might at least put a line under the manager to see if it requires further ongoing investigation. If the manager is continuing to lose substantial funds, there could be a number of reasons why. The fund could be running off because of retirements, but it could be because there are some issues with the fund. ■■■

