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Circular No. CMI 32/2020

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To: Holders of Capital Markets Services Licence for Fund Management under the Securities and Futures Act (Cap. 289)

Dear Sirs

GOOD DISCLOSURE PRACTICES FOR ACTIVELY MANAGED FUNDS

This circular highlights the findings from a thematic review carried out by the Monetary Authority of Singapore (MAS) on more than 100 equity funds with active management mandates offered by 19 fund management companies ("FMCs") to retail investors. Through a combination of desktop analysis and on-site visits, MAS reviewed (i) how FMCs sought to deliver value to investors through active management; and (ii) the disclosures made by FMCs on how funds were managed with respect to their reference benchmarks.

2 Active management refers to the management of a portfolio of securities in which the FMC makes discretionary investment management decisions, with the aim of outperforming a benchmark index by generating alpha. In return for this active stock-picking, FMCs typically charge management fees that are higher than passive or index-tracking funds. FMCs have different considerations and approaches to generating alpha. For instance, they can determine and vary the sector allocation, and overweight, underweight or maintain a neutral position on individual stocks within a selected reference benchmark. To manage concentration risk, FMCs can also set investment limits (such as securities or sector limits). If such limits or constraints are poorly designed, the portfolio could be limited in its potential to generate alpha, or may even underperform the reference benchmark on a net-of-fees basis most or all of the time. In other jurisdictions, regulators have found that some portfolio managers with active management mandates do not proactively seek opportunities to depart from the benchmark composition to generate alpha, even though higher fees are charged for active management.

3 MAS' thematic review did not find evidence that any of the 19 FMCs had set out to closely track the benchmarks of their active funds, and all had investment processes aimed at beating the benchmarks to deliver value from active management. However, we observed that disclosures of active funds' investment objectives and the extent to which the portfolios deviate, or can deviate from their reference benchmarks, could be improved. This circular

sets out recommended practices for FMCs to enhance such disclosures, and is intended to supplement the existing regulatory requirements for the offering of collective investment schemes.

Good Disclosure Practices

4 Our review found that the majority of fund disclosures[1] covered in the thematic review were generic. In particular, the investment management styles and the extent of active management, such as active share and tracking error, may not be immediately apparent to investors. In this regard, disclosures could be enhanced in several aspects:

Disclosure of Investment Style

5 A common observation was that fund factsheets and prospectuses did not always clearly set out how the funds were to be managed against their reference benchmarks. As the example below illustrates – seeking to achieve 'long term capital appreciation', in itself, does not provide any indication as to whether a fund would be actively managed to generate alpha, or would merely seek to achieve beta capital growth in tandem with the broader market. Such an ambiguous investment objective statement, in combination with other poor disclosure practices described in subsequent sections, impedes investors' ability to determine whether the higher management fees that active managers typically charge are justified.

Poor disclosure practice

"The investment objective of the fund is to achieve long-term capital growth through investing primarily in equity and equity-related securities listed on stock markets of countries in Asia."

It is a good practice to clearly state that a fund is to be actively managed. This includes describing how the FMC intends to carry out active management of the portfolio to derive alpha. The disclosure should be plain and easily understood by retail investors. An example can be found at paragraph 7.

Disclosure of Reference Benchmark and its Purpose

6 Where active funds are managed in reference to benchmarks, the relevant reference benchmark should be stated clearly in the fund documents. We found from our review of the

[1] "Fund disclosures" in this circular refers to disclosures in the prospectus, product highlight sheet and regular fund reports.

funds' prospectuses that in almost all instances, the reference benchmark was not mentioned and discussed in the investment objective section. Instead, it was stated nondescriptly in the fund performance section. Without articulating the reference benchmark when explaining the investment objective of a fund, FMCs would have missed the opportunity to explain upfront to investors whether or how investors can potentially benefit from or assess the value-add from their active management.

7 Regardless of where the reference benchmark was highlighted, MAS also observed that its purpose was not clearly set out in most instances. A clearer statement of the purpose of the reference benchmark would help investors better assess the fund's performance relative to its peers. The use of reference benchmarks may fall into the following categories:

- A benchmark used as a constraint for a fund's portfolio construction: In this case, a fund could be highly constrained to invest only in the constituents of a benchmark and is restricted from investing beyond the benchmark constituents.

- A benchmark used as a target for a fund to beat: In this case, the fund's portfolio of individual holdings, including the weight of each holding, is expected to deviate materially from those of the benchmark from time to time. Hence, if the fund aims to outperform the return of a reference benchmark, it should clearly state so.

Good disclosure practice: Making clear the purpose of a benchmark

"The investment objective of the fund is to achieve long-term capital growth through active management of its investment portfolio, by investing primarily in equity and equity-related securities listed on stock markets of countries in Asia. ***In doing so, the fund aims to achieve a net of fee return that exceeds that of XXX index."***

- A benchmark used solely as a reference for investors to compare against a fund's performance, whereby this benchmark is neither used as a constraint on how the fund's portfolio is to be constructed nor set as a target for the fund's performance to beat.

8 Where a fund is not managed in reference to any benchmark, this should be clearly stated in the fund documents, with an accompanying explanation of why a reference benchmark is not used.

Disclosure of Investment Constraints and Degrees of Active Management

9 Investment limits and constraints that are set for a fund will impact the fund's risks and returns. The extent to which a fund's composition or target performance can deviate from the benchmark composition and return are some examples of such constraints. In addition, FMCs generally monitor active share and tracking error as part of their internal investment and risk management processes. However, these were often not disclosed in the fund factsheets and prospectuses that MAS reviewed as part of this thematic exercise. As a good practice, FMCs should provide clear disclosures on how a fund's investment limits and constraints can affect the risks and expected returns of their funds. This includes disclosing the degree of freedom FMCs have, relative to the benchmark. FMCs should also disclose their funds' active share and tracking error on a regular basis, together with a clear and simple explanation of what these terms mean. Some examples are as follows:

Good disclosure practice: Composition of investment universe

"The majority of the fund's equity securities will be components of and have similar weightings to the benchmark. The investment manager has the discretion to deviate by 10% from the benchmark weights and invest up to a maximum of 10% in companies not included in the benchmark."

Good disclosure practice: Disclosure of tracking error

"The investment strategy will restrict the extent to which portfolio holdings may deviate from the XXX index significantly. This will limit the extent to which the fund can outperform or underperform the XXX index. The fund is expected to have an X% - Y% tracking error range vis-a-vis the XXX index. Tracking error reflects the difference between a fund's performance and that of its reference benchmark. It is calculated as the standard deviation of the difference between the returns of the fund and its benchmark.

10 The degree of active management should be described qualitatively, and supplemented by quantitative measures for investors to compare with peer funds.

Board and Senior Management Oversight

11 The Board of Directors and senior management of FMCs are expected to exercise effective oversight of the FMCs' operations. This includes the provision of clear, fair, balanced, and non-misleading promotional material, that fully comply with the relevant rules and

regulations. MAS expects FMCs to implement these sound disclosure practices over time, and improve their communication on how they seek to deliver value through their active portfolio management. While the review focused primarily on funds offered to retail investors, FMCs should also apply these practices to funds offered to other investor classes where appropriate.

12 MAS acknowledges that not all investors may fully appreciate the concepts and metrics described in this letter. In this regard, MAS will continue to work in collaboration with the industry on investor education initiatives to equip retail investors with the knowledge to benefit from better fund disclosures.

Yours faithfully

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CAPITAL MARKETS INTERMEDIARIES DEPARTMENT II