London Borough of Harrow
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Prepared for: The Pensions Committee
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Investing in a small vehicle (public equities)

Introduction

This short document highlights the issues that clients should consider when investing in a vehicle that has a low AUM.

Note that this note does not focus on the broader discussion regarding the relative merits of pooled versus segregated investing.

GMO Domestic Opportunities

The GMO Domestic Opportunities strategy has two pooled vehicles – a US Mutual Fund for its US-based investors and a Irish-domiciled UCITS ICVC. The strategy also has a handful of segregated accounts.

In total, the strategy has £1.7bn in AUM (as of 31 December 2013). The majority of this AUM is managed within the US mutual fund. At the time of writing, this strategy has not yet seeded its ICVC with client money. We understand from GMO that they have two clients who have indicated their intention to invest in this vehicle, although are not expected to fund until later this year. Both clients are intending to allocate circa £50m in AUM.

Despite being currently unseeded, we believe that the ICVC vehicle is the most suitable for the London Borough of Harrow.

Potential risks and costs of investing in a vehicle with low AUM

- **Increased costs (as a percentage of assets invested)**

  Investors in pooled vehicles are subject to transaction, custody, administration and non reoccurring costs which are typically borne by investors. These costs can be charged to the fund regardless of the size of AUM invested and consequently will have a larger percentage impact on small funds.

  Managers should be asked to cap non-management fees as a percentage of invested AUM, particularly in the early stages of a vehicle lifecycle.

  GMO has capped admin and expenses at 10bps p.a. for the lifetime of the fund, which we think is reasonable.

- **The cost of reduced flexibility**

  The opportunity to optimise disinvestment is limited in a smaller fund. If the manager is required to find short-term liquidity, then they may be forced to disinvest from illiquid positions or suffer opportunity costs from disinvesting from their best ideas.

  We recommend extra caution seeding vehicles where the manager is investing large proportions of the portfolio in illiquid positions.

  We do not believe that illiquid holdings are a concern for this strategy.

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- **Inability to scale trading costs**

  One of the advantages of investing in pooled vehicles is the ability to scale transaction costs. Smaller vehicles (within smaller strategies) do not have this benefit and so trading becomes a more expensive exercise. This assumes the Portfolio Manager is unable to consistently combine trades with other vehicles, separate accounts and even across the firm.

  We recommend extra caution seeding vehicles where the manager is executing a higher turnover strategy.

  This is not a buy-and-hold / low turnover strategy, however it is not a trading strategy. There is some overlap with GMO's other larger emerging market strategies which could provide some scale benefits.

- **Commitment to the strategy**

  If the parent strategy has low AUM (as well as the specific vehicle), there is a risk that the manager may terminate the product on the grounds of commerciality. This would trigger costs to the investor through re-allocating proceeds.

  We recommend that where strategy AUM is low, clients familiarise themselves with the rationale that the manager has for continuing to offer the strategy and consider the likelihood that the strategy will be able to raise new assets.

  We believe that this product is a core offering within GMO's Emerging Markets platform and we have conviction that it will gain traction with investors over time.

- **The impact of future investors on seed investors**

  Future investor capital will be used to replicate assets in the fund, for which the fund will incur costs. If the manager does not have a strategy in place to shield existing investors from being impacted by these costs, AUM growth could be detrimental to returns experienced by seed investors.

  We recommend that clients confirm that the manager has a mechanism in place for fairly distributing entry (and exit) costs between new and existing investors.

  GMO charges dilution costs which are high relative to the market (80bps on both entry and exit) which are paid into the fund. This should provide protection to seed investors.

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