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The 1998 Third Annual Survey of Risk Management Practices of Unit Trusts in Singapore

by

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Abstract: The recent liberalization of Singapore's financial sector causes its fund management industry to expand rapidly. As of December 1, 1998 there were already 191 unit trusts to choose from. Eventually, Singapore, like the USA and Hong Kong, will have more unit trusts than stocks listed on its exchange. Many challenges faced the industry in the recent past: (1) in 1997-98 the Asian Financial Crisis created a very difficult investment climate; (2) in 1997 the Investment Management Association of Singapore was registered as a *private* industrial body; and (3) in 1998 the Government introduced a multi-pronged strategy to make Singapore a premier fund management center in Asia in the next five to ten years. We report the results of an ongoing survey of the transformation of the fund management industry in Singapore and focus on the improvement of its risk management practices. This survey was initiated in 1996 and is continued under the aegis of the Unit Trust Research Unit of NBS' Centre for Research of Financial Services (CREFS). Overall we find a better industry awareness and more realism than in the preceding years. The quality of both the survey responses and of the reported risk management practices has improved in the past three years. The 1998 response rate was 25.9%, up from 11.4% in 1996, while the basis had expanded from 79 to 158 unit trusts. There is more disclosure of the managers' background, asset allocation, investment styles and various kinds of risk exposures. Regrettably, still two thirds of the unit trusts do not provide any risk analysis to their unit holders, because it is still *not common practice*. Currently, Singapore unit trusts diversify more to the developed markets in North America and Europe. But there is still an undue concentration on equity investments in Asia. OTC forwards often hedge currency risk exposures. But 70% of the respondents in 1998 thought that it was an excellent time to pick up sound common stocks at bargain prices in the region.

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1. INTRODUCTION

The local unit trust industry has grown phenomenally since the launch of Singapore's first unit trust, First Singapore Fund, in 1958. The recent liberalisation of Singapore's financial sector accelerated its fund management industry. As of December 1, 1998, there were a total of 191 unit trusts for an investor to choose from. Last year Peter Douglas of Aberdeen Asset Management Asia predicted that in five years' time, there will be 300 to 400 unit trusts available in Singapore with perhaps S\$10 billion of assets under management (Douglas, 1998). In particular, with the liberalisation of the Central Provident Fund Investment Scheme (CPFIS) in February 1998, the number of CPF-approved unit trusts has increased from 21 in March 1998 to the current 53. Eventually, Singapore, like the United States and Hong Kong, will have more unit trusts available to investors than stocks listed on the exchange.

In recent years, Singapore's fund management industry experienced three unprecedented upheavals in its previously rather placid business environment:

- (1) Starting with the collapse of the Thai baht on the 2nd of July 1997, the ensuing Asian Financial Crisis created a very difficult investment climate, with continuously changing risk parameters¹;
- (2) On 22 September 1997, the Investment Management Association of Singapore (IMAS) was registered as a private industrial association; and
- (3) In 1998 the Singapore Government introduced a multi-pronged strategy to make Singapore a premier fund management centre in Asia in the next five to ten years, and proceeded to liberalise its banking sector in the spring of 1999.

This paper reports the results of an ongoing survey of the emergence and transformation of the unit trusts in Singapore, with its focus on the improvement of their risk management practices, and comparing their level of risk transparency and disclosure to that of similar mutual funds in the USA. This research project was initiated in 1996. Since November 1998, it continues under the aegis of the Unit

¹ As analyzed in Los (1998). The results were presented in a paper at the Sixth Conference on Pacific Basin Business, Economics and Finance, Hong Kong, 28 – 29 May 1998 and at the Asia-Pacific Risk and Insurance Association, The Second Annual Conference Proceedings, 19 – 22 July 1998, pp. 153 – 187, Singapore, where it received an Outstanding Paper Award.

Trusts Research Unit of the Centre for Research in Financial Services (CREFS), at the Nanyang Business of the Nanyang Technological University in Singapore.

Under the impact of the recent challenges, there is now much better industry awareness of professional risk management practices and more realism than three years ago. The quality of both the survey responses and of the reported risk management practices has improved. The 1998 response rate was 25.9%: 41 of the 158 questionnaires sent out in September 1998, were returned by December 1998. This was up from 16.8% (21 out of 125) in 1997 and 11.4% (9 out of 79) in 1996.²

Regrettably, despite the recent market upheavals, two thirds of the unit trusts do not provide any risk analysis to their unit holders, because it is still considered: “not common practice”. On the other hand, Singapore unit trusts diversified more to the developed and stable markets in North America and Europe to reduce their optimal portfolio risk. There remains an undue concentration on equity investments, and the currency risk exposure remains high. Only half of the respondents hedged their currency risk. However, 70.4% of the respondents in the fall of 1998 thought that it was already an excellent time to pick up common stocks at bargain prices in the region.

This paper is organised as follows. Section 2 reviews previous research in this area and discusses the design of the survey questionnaire. Based on the survey, Section 3 provides the background of the respondents and their investment styles. Section 4 provides an inside in what the Singapore unit trusts disclose to their clients in terms of return (sufficient disclosure) and risk (insufficient disclosure) and to what variety and magnitudes of risk they are actually exposed. Responses were collected regarding the most important market risks: country, currency, equity, and interest rate and credit risks. Also was asked what risk management tools the Singapore unit trusts currently use to measure these risks and how much they disclose of their risk analysis to the unit holders. In Section 5, we look at a diversity of back-room risks: liquidity, operational, regulatory and human factor risks faced by the unit trusts. Finally, Section 6 discloses what Singapore fund managers think of the increased competition,

² Los (Winter 1998/99).

the current regulation of the industry and the effectiveness of the market promoting strategies of the Singapore government, in the aftermath of the Asian Financial Crisis. The Conclusions section contains some recommendations and expectations regarding the future of the disclosure of risks among unit trusts in Singapore.

2. REVIEW AND DESIGN

The preliminary survey three years ago was inspired by a 1995 Biennial Performance Survey (with a 17.3% response rate) of 550 money managers by The Spaulding Group, a consulting firm in New Jersey and information provider to the money management industry in the USA. Morningstar Inc., the firm in Chicago, which monitors ca. 10,000 mutual funds in the USA, provides a reasonable standard of disclosure of risk management. Currently, the Association for Investment Research and Management recommends performance presentation standards for fund management on a global basis (Cf. AIMR, 1996 and 1998). Technical details of the various risk performance measures, and the motivation for each of these measures, can be found in the recent book by Spaulding (1997).

The book by Bernstein (1995) inspired questions related to style investing, which provide a unique insight into equity management. Considering that many unit trusts are offered to the public both domestic and foreign banks in Singapore and that derivatives become a more important ingredient of the investment menu, a few questions related to Value-at-Risk were also included, following Jorion (1997).

In the first survey in 1996 (Cf. Lim, Lim and Tan, 1997), it was found that most unit trusts in Singapore were equity funds and most funds did not provide comprehensive risk analysis to the public and rarely disclosed information about their risks and fund managers to the public. Next year's survey reported that Singapore unit trusts still did not disclose adequately their risk management practices to investors, which could be a negative force impeding the growth to maturity of the unit trust industry in Singapore (Cf. Ong, Lim, Lim, 1998). On basis of that second report it was decided to conduct this survey annually to monitor the industry, as well as to explore whether there would be any changes forthcoming in the risk management practices. During this Third Annual Survey, in November 1998, the Unit Trust Research Unit of CREFS

was headed up by the author, to institutionalise the continuation of this private annual survey, which is conducted independently from the Singapore government.

In early 1998, the *Asian Wall Street Journal* reported that when Asian currencies and markets plunged in 1997, many local fund managers sold stock and sought a safe haven in cash, but subsequently reduced their cash holdings in the early part of 1998.³ This raised questions about their investment behaviour. Were their redemptions reduced, did they diversify and invest elsewhere, or were they going out of business? According to Merrill Lynch (ML), which every month conducts its own survey of Asian-based fund managers, the average cash level in an Asian portfolio was 9% in November 1997. Already the following month, December 1997, this figure had increased to 19% -- the highest average cash level recorded since the ML survey began in early 1997. Therefore, in this 1998 survey questions were incorporated to determine how the Asian financial turmoil has affected Singapore's unit trust industry.

In addition, a local *Straits Times* article reported that out of 69 Singapore unit trusts, only 13 managed to increase in value for the calendar year 1997, according to British fund monitor Micropal⁴. The remaining 56 chalked up negative returns. Seven out of the 13 positive funds were either global, American or Asia-Pacific funds, five were invested in Asia, and only one fund, Aberdeen Singapore Growth, was fully invested in Singapore. All these funds in general did well compared with their respective benchmarks. Thus, global diversification appeared to hold the key to security for Asian fund managers, as had already been demonstrated and recommended in Los (1998a & b).

A 19-page questionnaire was designed with 81 questions to obtain the relevant primary data. The survey was targeted at all unit trusts listed in the main local newspaper in Singapore, *The Straits Times*. A total of 158 questionnaires were sent out at the beginning of September 1998, to which 41 unit trusts had responded by November 1, 1998, the deadline for the survey. The questionnaire has seven sections:

³ "Asian Fund Managers Cut Portfolios' Cash Holdings", *The Asian Wall Street Journal*, 26 February 1998, p. 8.

⁴ *The Straits Times*, Sunday Review, 18 January 1998, "Diversification big lesson of 1997", p5.

Background, Investment Style, Returns, Risks, Risk Management Tools, Competition, General. To maintain comparability, most of the content of the questionnaires of the preceding years was retained, although in re-edited form. New questions were added in the General Part G to investigate the fund managers' views on three key issues relating to recent developments in the Singapore unit trust industry.

For the tabulation of the survey results, percentages were computed based on the number of responses to each question. Different questions had different response rates, as indicated. The complete 1998-survey questionnaire and its very detailed responses can be downloaded from the web: <http://www.ntu.edu.sg/nbs/crefs/>.⁵

3. BACKGROUND AND STYLES

This section discusses the core results from the survey on background, self-categorized investment styles and degree of disclosure and transparency of the unit trusts in Singapore.

3.1 Background

Here we review the self-categorization of Singapore's unit trusts, their asset allocation in the fall of 1998, income distribution, the adoption of formal investment policies, their disclosure of manager background and how much they claim to be in compliance with the AIMR Standards.

Six out of the 41 respondents are insurance-linked funds and all six of them contract out their funds to private management. Nineteen (26.3%) of the 41 responding unit trusts are CPF-approved funds. This is 16.9 percentage points higher than the 29.4% in 1997. This considerable rise in the number of CPF-investible funds is the outcome of the liberalization of CPF savings by the CPF Board in early 1998. Twenty-six (63.4%) of the 41 responding unit trusts are only available in Singapore.

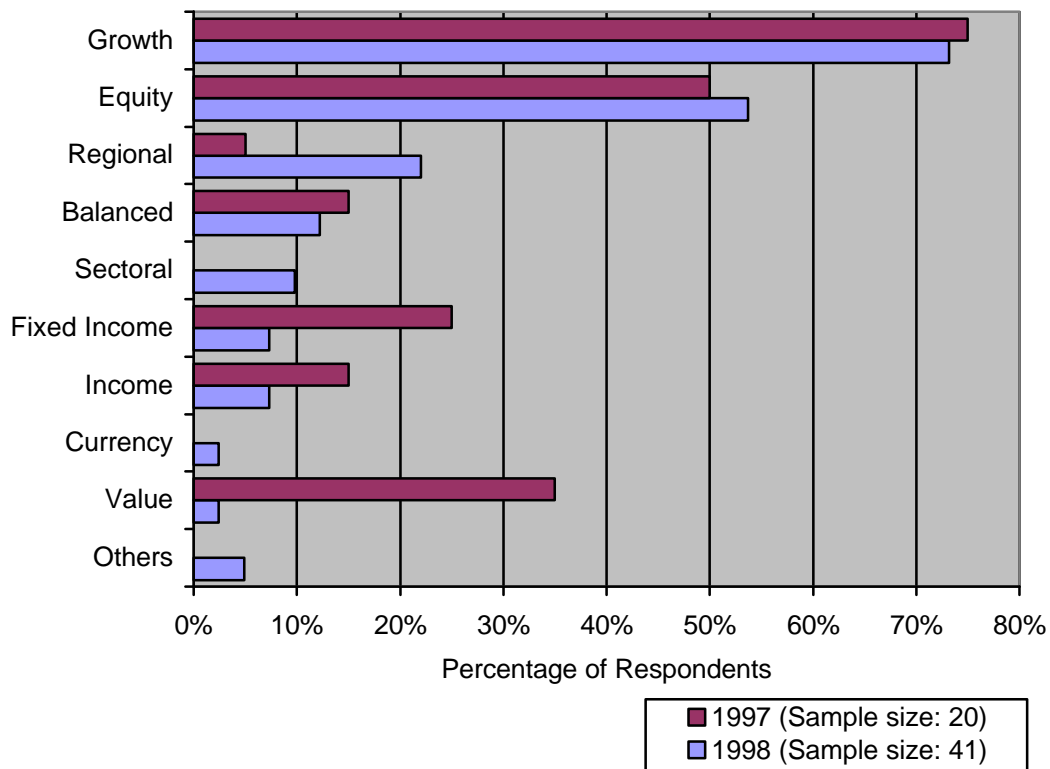
Figure 1 shows that thirty (73.2%) of the 41 classify themselves as growth funds. This remains relatively unchanged from last year's response of 75% (out of 20). From

⁵ The survey has been featured in "Unit Trusts: Better disclosure required", *Asia Asset Management (The Journal of Investments & Pensions)*, Vol. 4, No. 4, April 1999, p. 8.

1996 to 1997, the number of value funds increased from zero to seven (35%) out of 20 respondents, to ten (24.4%) out of the 41 in 1998.

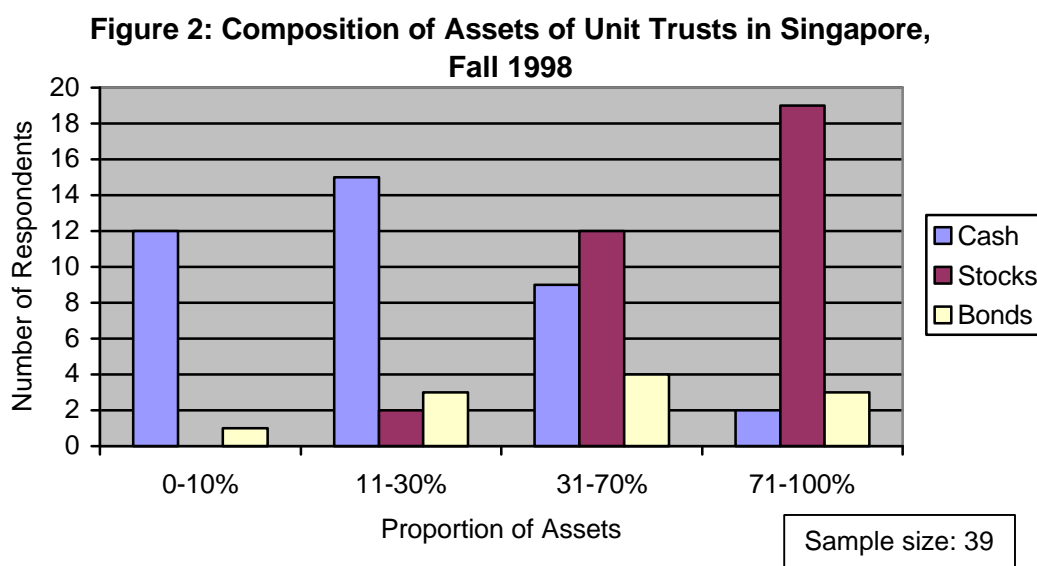
The low popularity of fixed income funds among local investors was re-emphasized in this survey, where only three out of 41 respondents described their unit trusts as fixed income. Underdeveloped bond markets coupled with investors' unfamiliarity with bond instruments are likely to have attributed to this trend. With the Singapore Government currently promoting the development of a bond market, this trend may improve in the near future with a higher number of fixed income unit trusts. On the other hand, the category of value funds saw a similar decline in popularity.

Figure 1: Self Categorisation of Unit Trusts in Singapore



This year's survey experienced a surge in the number of regional and sectoral funds. Indeed, there was a flood of new global-theme funds onto the Singapore market. This may be attributed to market niche-ing, to make available more innovative unit trusts to consumers, such as technology funds and health funds. Under the sectoral category, there is an increase from a zero percent in 1997 to 11.4% in 1998. The regional funds now counted for 13 out of 41 respondents, a 26.7 percentage point increase over 1997's meager 5%.

As Figure 2 shows, similar to last year's results, two thirds of the funds (21 out of 33) kept cash holdings ranging from zero to 30% in their investment portfolios to facilitate liquidity. Unlike last year, the number of unit trusts keeping cash holdings of 31-70% has increased by 16.1% points to 27.2%. Inferring from a question in the later part of the survey, the Asian financial turmoil appears to have been a major reason for maintaining higher cash holdings.



Compared to the 1997 results, more unit trusts distributed income to their unit holders in 1998. Twenty-two (62.9%) out of 35 respondents distribute income annually in this year's survey, while only two out of eight did so in 1997's survey. The remaining 37.1% does not distribute any income at all, but ploughs the returns back into the portfolio.

An investment policy acts as a signpost for fund managers to achieve their investment objectives and to satisfy their risk tolerance. It helps fund managers to stay focused in the execution of investment strategies, as well as to help guard against excessive risk taking in any particular sector or country. To investors, an investment policy aids in the selection of unit trusts with investments or exposure that matches the investors' risk-return objectives. Hence, it is encouraging to see that there has been a steady improvement in the number of unit trusts that have articulated investment policies, in addition to what little they can register with, from 63% in 1996 to 90% in 1997 and 93% in 1998.

On the other hand, it is disheartening to see the percentage of unit trusts that provide fund manager information, e.g., the educational background and years of experience, fall from 1997's 62.5% (10 out of 16) to this year's 24.2% (8 out of 33). Such information is important for assuring investors that their savings are in good hands. Fourteen (58.3%) unit trusts indicated that the provision of manager background information is "not common practice" in Singapore. (See also Section 5.4).

On the other hand, 88.9% of the 36 respondents stated that their management teams are now undergoing training in risk management and 93.8% stated that they differentiated between functional areas to reduce operational risk. Indeed, 70.7% of the 41 respondents stated to be very well protected from unethical practices by their management team and 29.3% were well protected. This emphasizes the "clean practice" standards for which Singapore is rightfully famous. The team approach to investing is favored among Singapore's unit trusts and "stars" among the (mostly very young) unit trusts managers are (still) unheard of. About three-quarter of the teams consist of less than five people, most of them engaged in research and analysis.

Slightly more than half (51.9%) of 27 respondents claimed that they are in compliance with the AIMR Performance Presentation Standards, an improvement over last year's 31%. The five unit trusts which responded to the second part of this question indicated the reason for not implementing the AIMR standards as "not a regulatory requirement", while three indicated that it is "not a common practice". Only one of the respondents cited high costs and questionable benefits as the reason for not implementing the AIMR Standards. The low rate of compliance may be related to the fact that 62.9% of these unit trusts are available only in Singapore. Singapore does have a reasonable number of Chartered Financial Analysts (CFA), but more than a fifth is employed by the GIC and the others are mostly portfolio managers in broker-dealer investment banking, with few CFAs in local fund management positions of importance.⁶

⁶ According to Ng Kok Song, the Deputy Managing Director of Singapore's Government Investment Corporation (GIC), there are 234 CFA charter-holders in Singapore, of whom 51 are currently

3.2 Investment Styles

Not surprisingly for Asian Tigers, as Table 1 shows, 14 (56%) out of 25 respondents indicated “growth” as their equity investment style. Growth style managers look for companies that offer above-average opportunities for growth. Out of these 14, five are of large size, seven of medium size and two of small size. Rather in contrast to Singapore’s usual “kiasu” style of investing, only one of 25 respondents adopted the value investment style. Value style managers focus on potential value gains, looking for opportunities when stocks are “cheap”. Ten of 25 responding unit trusts were of the blend investment style, i.e., a mix of growth and value styles, with seven in the medium size category. Still, three possible style categories were still missing from this spectrum and opportunities for niche marketing exist.

Table 1:	Equity Style (Sample: 25)		
Size/Style	Value	Blend	Growth
Large	1	3	5
Medium		7	7
Small			2

Regarding the various bond investment styles, Table 2 shows that seven of the nine responding unit trusts indicate that they have a medium maturity period, of which, five are of medium quality and two are of high quality fixed income style. Only two are of the short maturity, high quality fixed income style. It is clear that bond styles are underrepresented in Singapore: only three out of nine possible style categories are available to the public. There should be more choices to invest in bonds.

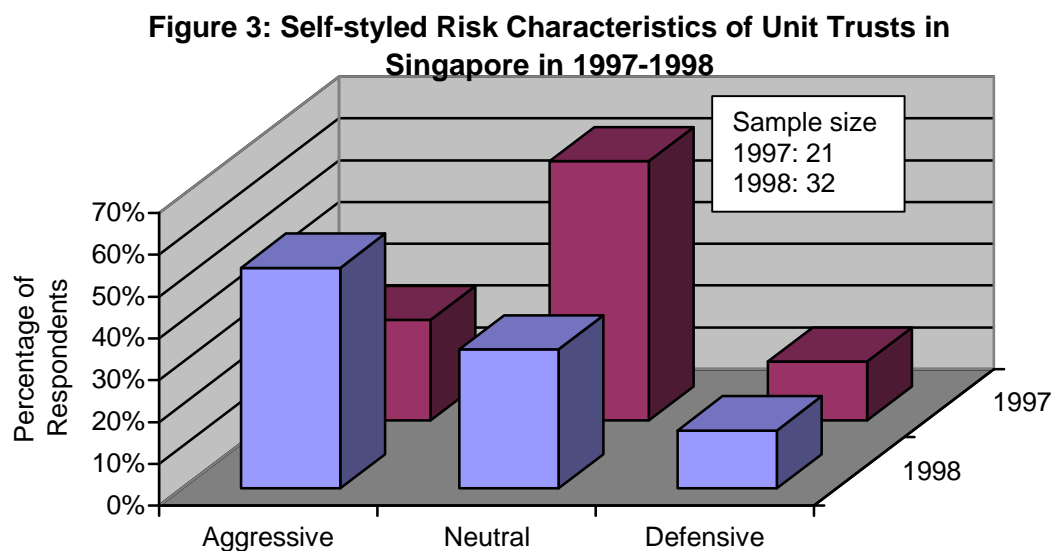
Table 2	Fixed Income Style (Sample: 9)		
Quality/Maturity	Short	Medium	Long
High	2	2	
Medium			5
Low			

Singapore’s unit trust managers use a bewildering array of 39 style benchmarks to measure their performance against (enumerated in the web report). Different unit trusts have different characteristics that cannot be generalized using a common

employed by the GIC. The total membership of the Singapore Society of Financial Analysts is 377, of which 86 state to work in an investment company/mutual fund.

benchmark for all unit trusts. Many variations of the same benchmark are also observed. Of course, with so many different benchmarks, it is difficult to compare the relative return/risk performances of the fund managers within Singapore. Of course, the relevant comparison benchmarks are all the fund managers in the world who use the same benchmarks.⁷

Figure 3 summarizes the risk characteristics of Singapore's unit trusts for both 1997 and 1998. In 1998 more funds were self-categorized as aggressive, while in 1997 the majority of the funds was described as neutral. With the increase in the proportion of self-styled aggressive funds, more emphasis should be placed on better risk management.



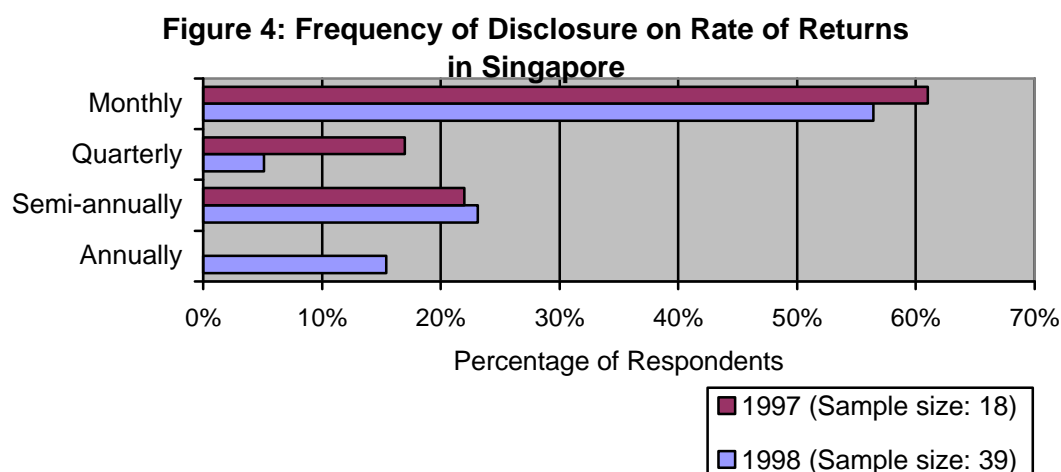
4. DISCLOSURE OF RETURN AND RISK

This Section looks at the kind of information Singapore's unit trusts disclose to their unit holders, in particular the disclosure of the returns and of the risks involved in achieving those returns. It also reviews the risk management tools currently in practice by unit trust managers in Singapore.

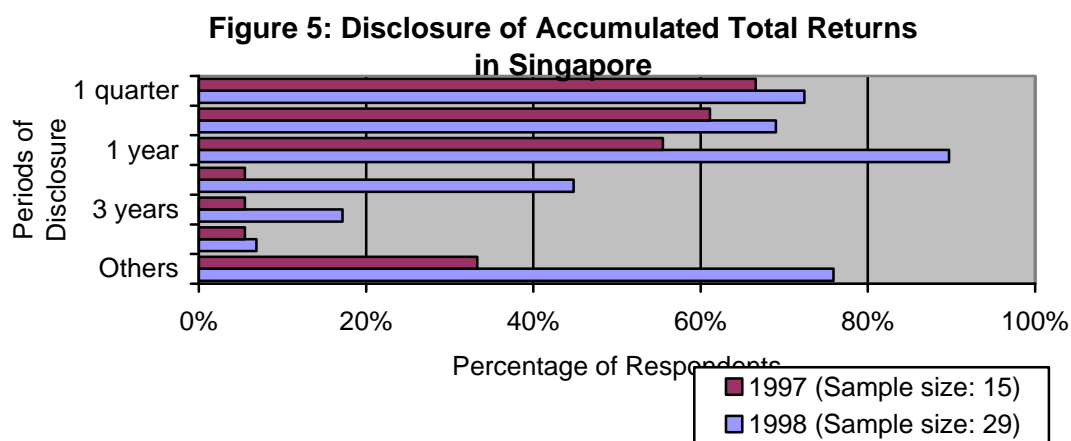
⁷ On April 4, 1998, IMAS started to produce a monthly ranking of 127 unit trusts in Singapore, based on only their returns and accumulated returns, without accounting for the risks involved, similar to the *Business Week's* "Mutual Fund Scoreboard" in the USA. This return ranking can be accessed on the web: <http://www.imas.org.sg/html/unittrustfr.html>

4.1 Disclosure of Returns

In accordance with the monthly IMAS ranking, which became available last year, 22 (56.4%) of 39 respondents indicated that they do provide the general public with rates of return on a monthly basis. This is about the same as last year's 61%. The number of unit trusts providing information on annual rates of return increased from zero to six this year. Higher reporting frequency and time frames are beneficial for both investors and fund management teams as they provide greater insight into how the managers' investment strategies are performing, and how their accounts are doing relative to benchmarks and to each other. Figure 4 summarizes how the frequency of disclosure on rates of return has changed over the past year.



Out of 40 respondents, 29 (72.5%) stated that they do present accumulated total returns to their unit holders, a slight decline from last year's 83.3%, with the majority providing quarterly, half year, one and two year accumulations, as shown in Figure 5.



The proportion of unit trusts presenting accumulated total returns to unit holders on a short-term basis for one and two years increased sharply. First, many funds in Singapore are very young and have only short historical records of two to three years. But this picture will gradually mature. Second, the new guidelines regarding disclosure to unit holders and the CPF Board require that certain information be disclosed on a quarterly and half-yearly basis, to the CPF Board and unit holders, respectively.⁸

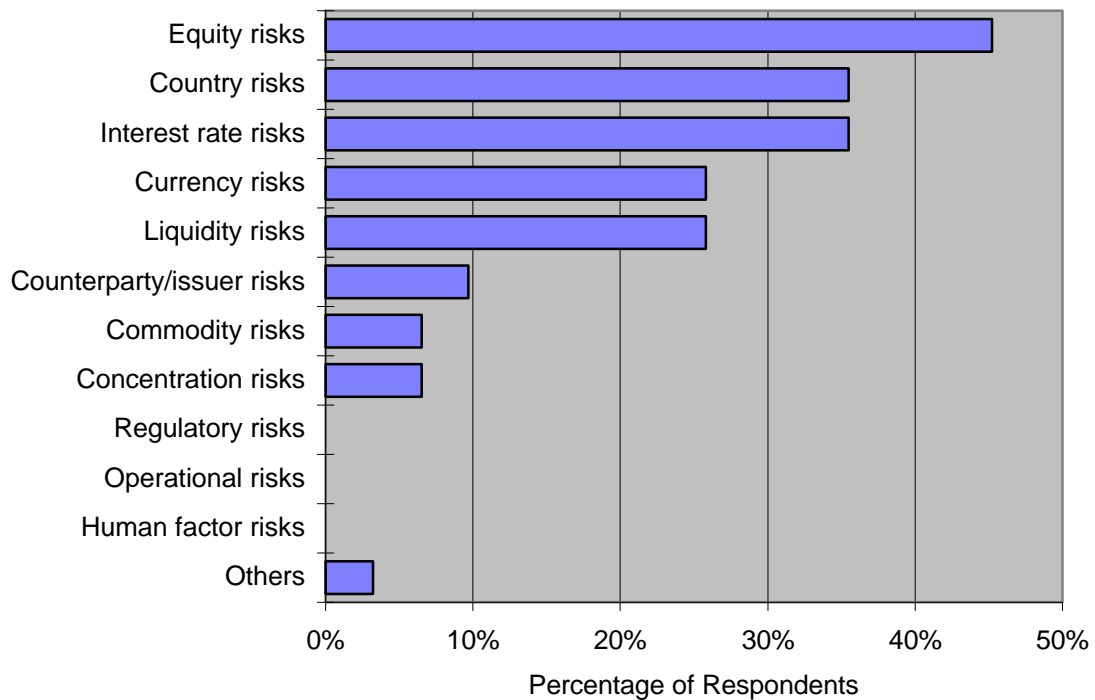
Only two trusts presented accumulated total return rates for periods exceeding five years. This is in agreement with the unit trusts' claim that their average investment horizons are now between one and five years. It was considerably shorter in the first two surveys. Apparently, the view of the unit trust managers in Singapore is changing from short term, trading oriented, "money" management to "medium term", multi-currency, "buy-and-hold" strategic management.

4.2 Disclosure of Risks

The questionnaire asked which type of risk was considered to be most important in the eyes of a unit trust manager in Singapore. Several respondents ticked more than one type, a sure sign that, in these times of volatile market conditions, no particular type of risk dominates. The unit trust managers are also increasingly becoming aware of the need to address and mitigate various risks that they are subject to. But in contrast to the preceding two years, 14 (45.2%) of the 39 responding units ranked equity risk as the most important risk, while 11 (35.5%) of them considered country risk on par with interest rate risk. This was followed by currency risk on par with liquidity risk (8), as shown in Figure 6. The implication is that Singapore unit trust managers now tend to focus their risk management techniques and tools on alleviating such risks. The results of Figure 6 are consistent with the finding that the majority of the unit trusts in Singapore are equity funds, and that most have a regional or global theme in their investment policies.

⁸ CPF – Central Provident Fund, the sophisticated all-in social security (retirement and health insurance) fund in which all Singaporean Citizens and Permanent Residents must participate.

Figure 6: Risks Considered Most Important by Unit Trusts in Singapore (sample: 31)



It is likely, although not analyzable from the current questionnaire responses, that the nine fixed income respondents would find interest rate risk to be more important, while the 25 equity style funds would find equity risk, currency risk, liquidity risk and country risk all important.⁹

Only 12 (32.4%) out of 37 respondents indicated that they provide a risk analysis of their unit trust for their unit holders. Of these 12, ten provide such information qualitatively, while two do so both quantitatively and qualitatively. Of the 25 respondents (67.6%) who had stated that they do not provide a risk analysis for their unit holders, 19 cited the reason that it is “not a common practice”, while three attributed it to the absence of regulatory requirements.

In addition, only 21 (75%) of the 28 responding unit trusts in Singapore was willing to reveal their average sector weightings. Thus it is very difficult for unit trust holders in Singapore to form even a rough idea of the risk exposure of his share in the unit trust.

⁹ In the aftermath of the Asian Financial Crisis, we hoped to find out what the managers meant by country risk – political risk or economic risk. But, as in the preceding surveys, no response was given to Question 65, which differentiates between those risks. In addition, none of the manage of the unit

It is clear that the majority of the unit trusts in Singapore do not offer their clients information about the investment risks involved. Even among those few unit trusts, which do, most do not provide the information in quantitative form.

Perhaps, the underlying reason for this finding is the low level of investor sophistication in Singapore, which in turn results in unit trust companies presuming that such information would not prove useful to investors at large, due to their lack of knowledge and skill in interpreting such information. Substantial changes can then be expected to come, because the retail investor in Singapore is becoming quickly more sophisticated, especially now with the recent move towards a disclosure-based regulation regime and the influx of foreign mutual funds for sale.

4.2 Actual Exposure to Market Risks

4.2.1 Country Risk

As is to be expected of a small city-state, 38, or 95% of 40 responding funds invest overseas, mostly in Hong Kong (26), several emerging markets – Malaysia, Thailand, the Philippines, Indonesia and, surprisingly few still, in mainland China, as shown in Table 3.

Table 3: Countries Where Singapore’s Unit Trusts Are Invested

Country	Number of times selected
Hong Kong	26
Malaysia	19
Thailand	18
The Philippines	12
North America	11
Indonesia	10
Western Europe	10
China	7
Eastern Europe	3
South America	2
Others	18

trusts in Singapore was willing to rank which of the ASEAN countries they view currently as a politically high risk.

Almost half (45.5%) of the funds which state to invest overseas has 76-100% of their funds invested overseas. The questionnaire responses show that funds with three-quarter of the funds invested overseas in 1997 were split between the ones, which increased their overseas holdings in 1998, and the ones, which decreased their overseas holdings in 1998. The first group probably increased their diversification to North America and Western Europe after the Asian Financial Crisis¹⁰. Another reason for this group could be due to the increase of the number of global funds in the Singapore market, which have automatically a large proportion of their funds invested overseas. What is clear is that the second group retrenched and reduced their exposure to the overseas market, especially in Asia.

As in previous years, 25 responding unit trusts in Singapore rank economic risk as the most important factor to take into consideration when investing overseas. Political risk is ranked second, regulatory risk third and natural calamity risk as fourth. For 19 respondents, Singapore was once again the ASEAN country with the lowest political risk, followed closely by Brunei, The Philippines and Thailand. With the recent political pandemonium in Indonesia, it is not surprising that it is ranked as the second most politically risky country in the region this year. The most politically risky country, according to these unit trust managers, is Cambodia.

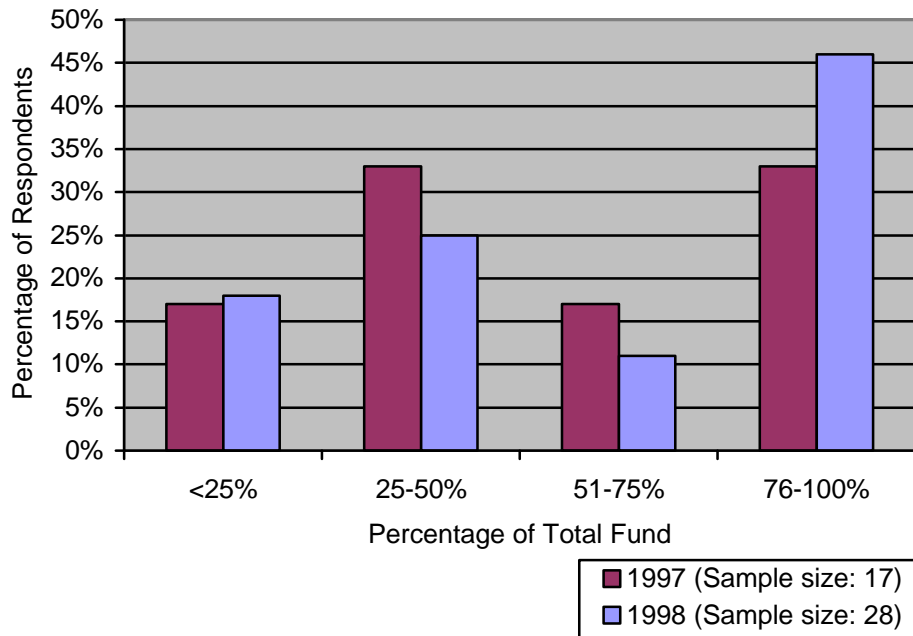
4.2.2 Currency, Equity and Interest Rate Risks

Among those, which invest in foreign assets, 13 of 28 respondents in 1998 are more than 75% invested in foreign currency assets, translating into potentially high currency risk exposures. This is not surprising, since most of the unit trusts in Singapore have regional and global investment policies. Figure 7 shows that, comparing 1998 with 1997, there is a larger proportion of our respondents with less than 25% of their funds invested in foreign currency assets, but a considerable larger proportion with a 75%-100% currency exposure. This is in line with our earlier observation of the two groups of Singapore fund managers. One group withdrew from the foreign markets, possibly being hurt by the Asian Financial Crisis. The other group increased their foreign exposure, but now further away from the South-East

¹⁰ Optimizing Asian portfolio managers could, by diversifying to the USA double their average return and halve their risk, as measured by the optimal portfolio's standard deviation (Cf. Los, 1998b)

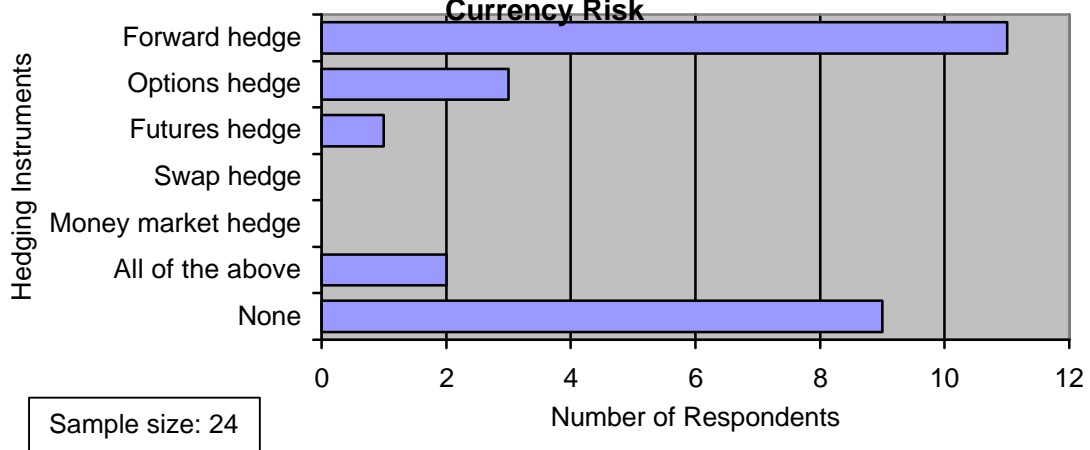
Asian region to less correlated and more stable North-America and Western Europe, to increase their diversification and reduce their unsystematic risk exposure.

Figure 7: Proportion of Investment in Foreign Currency Assets by Singapore Unit Trusts



Among 27 responding unit trusts, only eight classified their exposure to currency risk as very much, while 19 regarded it either small or neutral. This could be attributed to the fact that several fund managers use now sophisticated hedges against currency risks, as shown in Figure 11, mostly by forwards and option hedges. The nine unit trusts that indicated “none” of the listed hedging instruments are used stated that they rely on currency diversification to reduce currency risks.

Figure 8: Steps Taken by Singapore Unit Trusts to Counter Currency Risk



Of 30 respondents, an overwhelming 27 (90%) declared that they have more than 40% of their funds invested in equities. This is consistent with the response to an earlier question where equity risk was among those to be considered of greatest importance. In the aftermath of the Asian financial Crisis, which caused stock markets in the region first to collapse and then (some) to recover, it should come as no surprise that 23 (88.5%) of the 26 responding firms felt very much affected by the volatility of the stock markets. Fifteen of these funds coped very well, but eleven only moderately well. However, no less than 19 unit trusts thought it was time to pick up sound stocks at bargain prices.

There are few bond specialists among Singapore's unit trust managers, but five out of ten respondents indicated that they use duration analysis for measuring interest rate risk. Also, three use duration targets for individual portfolios, one uses them for the entire balance sheet, and one uses them for both of the above. Further one unit trust uses the appropriate zero-coupon yield for the computation of modified duration, whereas four trusts use a separate rate for each portfolio item.

4.2.3 Concentration Risk

Regarding concentration risk, the respondents were asked to give a breakdown of their sectoral allocations. Although most unit trusts in Singapore don't provide this kind of detailed information to their clients, the results in Table 4, for 18 respondents, show that many allocations are relatively small (<5%), imply that for most unit trusts there is a substantial degree of sectoral diversification. However, the level of concentration risk inherent within a unit trust would ultimately be a function of its investment objectives as outlined in its policy. The more popular sectors invested in by unit trusts in Singapore are energy, financial, and technology.

Table 4: Sector Weightings of Assets

	<1%	1-3%	4-5%	6-10%	11-20%	21-50%	51-100%
Utilities	1		3	4	1		1
Energy	1	2	4	8			1
Financial	2			4	7	1	
Industrial Cyclicals	4	2	2	5			
Consumer Durables	4	5	2	1	1	1	

Consumer Staples	5	4	1	2	1		
Services	3	1	3		3	3	
Retail	6	2	2	1			
Health	6		1	1	1	1	
Technology	2	1	3	1	4	1	2
Others	2	1	3	1		1	1

In fact, 21 (75%) of the 28 respondents did not provide sectoral disclosure of their assets to their unit holders. But the seven who did represented a marked improvement over last year, when none of the 16 respondents to this same question provided such disclosure. Still, this aspect of disclosure leaves much to be desired, considering that it is a common practice to disclose such pertinent information in the United States, as shown by the mutual fund fact sheets of MorningStar Inc., for example.

4.2.4 Credit Risks

Given that the Asian Financial Crisis was exacerbated by weak bank lending standards and the resulting non-performing loans, one would expect increased interest among the fund managers in the issue of credit risk, were it not that only 11 (27.5%) out of 40 respondents have some bond exposure in Singapore. Only five unit trusts can be considered bond funds and these five (out of 23 respondents) indicated that they break down their investments by credit quality class and/or counterpart type. Two did not do so, and 16 unit trusts indicated that it was not applicable since they were invested in stocks only. All five, who did consider credit risk, indicated that they have mandated or regulatory limitations with respect to the amount of funds in their unit trust that can be invested in each category. One out of six revealed an average investment horizon of less than a year, and five out of six have average investment horizons of 1-5 years. The longer the investment horizon, the higher the credit risks.

4.2.5 Commodity Price Risks

Considering that Southeast Asia produces a lot of raw materials – oil, gas, tin, gold, rubber, palm oil – the continued about commodity price risk is rather remarkable. This year for the first time we obtained a few responses to this section. The commodities invested in by the two respondents are represented in the table below. Unfortunately, we only managed to solicit one response for the next question where

we tried to discover what steps are being taken to counter commodity risks. Our sole respondent indicated that this was done via diversification, to minimize the specific risk.

4.3 Risk Management Tools

Another telling response for the overall lack of analytical disclosure to the unit holders by Singapore's unit trusts was that, although 15 (75%) of the 20 responding trusts use the standard deviation of the unit trust returns to measure risk, they did not reveal this information to their unit holders. Two responding unit trusts use the beta and two Sharpe's measure to measure relative risk and risk-adjusted returns, respectively, but only for in-house analytical purposes.

None of the unit trusts directly mentioned optimization of their portfolio along the lines of the Nobel Prize Winning mean-variance optimization of Markowitz (1991) or J.P. Morgan's *Riskmetrics* (Cf. Longestacy and Spencer, 1996). However, one unit trust uses the advanced Value-at-Risk (VaR) measure, i.e., a measure of absolute portfolio risk, which emphasizes the amount of capital that can be lost with 95% probability, under assumption of the normality of the trust's returns. Half (5) of the responding defined fixed income funds use duration analysis to measure risk. Again, both VaR and duration analysis are only used for internal purposes.

There was an increase in the percentage of managers performing simulation analysis over the three years for stress testing. Slightly less than half of the respondents did so. However, only 31.3% did it on a monthly basis, unlike the previous year where three-quarter of them performed it monthly.

5. DIVERSE NON-MARKET RISKS

Besides market related risks, unit trusts fail also liquidity risk resulting from unforeseen redemptions, operational risks from the possible failure of electronic accounting systems, regulatory risks from unanticipated changes in the regulatory

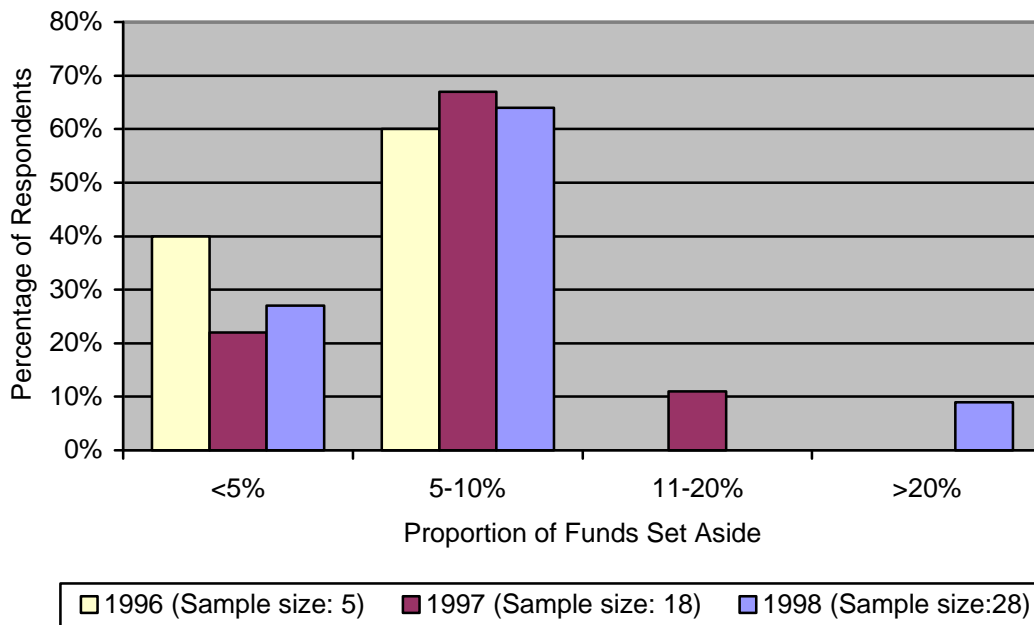
environment and human factor risks, the most difficult to assess of them all. How do Singapore unit trust managers view these risks?

5.1 Liquidity Risks

Unit trusts are likely to be concerned about liquidity risk produced by redemption in volatile times, such as caused by the Asian Financial Crisis. But a large majority of unit trusts in Singapore expressed confidence in being able to meet redemption needs in the event that a large number of unit holders redeem their units at the same time. In fact, only one out of 28 expressed a probability of less than 60% in the ability to do so, while 23 cited a probability of more than 80%.

Six respondents confidently set aside not more than 5% of their funds for such redemption requirements, and 20 set aside 5-10% of their funds. But two respondents projected a more conservative disposition by setting aside more than 20% of their funds, quite possibly the result of prevailing uncertainty in the market conditions they actually faced, as shown in Figure 9.

Figure 9: Proportion of Funds Set Aside by Singapore Unit Trusts to Meet Redemption Needs



Sixteen of the 28 respondents revealed that more than 40% of their (relatively small percentage of) funds set aside for redemption purposes were invested in liquid assets.

5.2 Operational Risks

It was found that only seven (25 %) of 28 unit trusts use on-line asset management accounting systems, while 21 (75%) that use a time-interval update system indicated that information is fed to headquarters on a daily basis to compute the daily Net Asset Value (NAV) of Singapore's unit trusts. Also, a healthy 21 (51.2%) of 41 unit trusts used marked-to-market accounting systems. Ten (52.5%) out of 19 respondents developed their asset management accounting system in-house, while the other nine had purchased it from outside vendors. Fifteen of 31 unit trusts used their asset management accounting for portfolio restructuring and optimization analysis, 14 for budgeting and financial planning, ten for divisional performance measurement and only one for interest rate risk analysis. Thus the earlier mentioned duration analyses are mostly done off-line.

Among 32 respondents, 11 used a PC network form of accounting system, 14 use a decentralized system, and seven use a centralized system. High operational risk is usually associated with the operational concentration of a centralized system, which requires an excellent backup system. Thus an increase in the number of users of decentralized systems is to be interpreted as a positive indication. Encouragingly, all 32 (100%) respondents have a backup system. Nevertheless, it appears that the extent of recovery by the backup systems is found to be lacking considerably, since 14 (43.8%) of the unit trusts can recover only 50-80% of the current system. Compared to the backup rate standards of close to 100% by the global financial industry, there is a lot of room for further improvement in the backrooms of Singapore's unit trusts.

Twelve (46.2%) out of 26 respondents seek external investment advice when making investment decisions, which either demonstrates a need to seek independent opinion or a lack of in-house research analysts. Of these 12, half uses such advice half the time, whereas the other half uses it "on a very frequent basis". As for the 14 (53.8%) others who do not use external investment advice at all, it may reflect either confidence placed on the expertise of their own fund managers, or the availability of an internal financial analysis department. Large and resource-rich banks manage most unit trusts in Singapore.

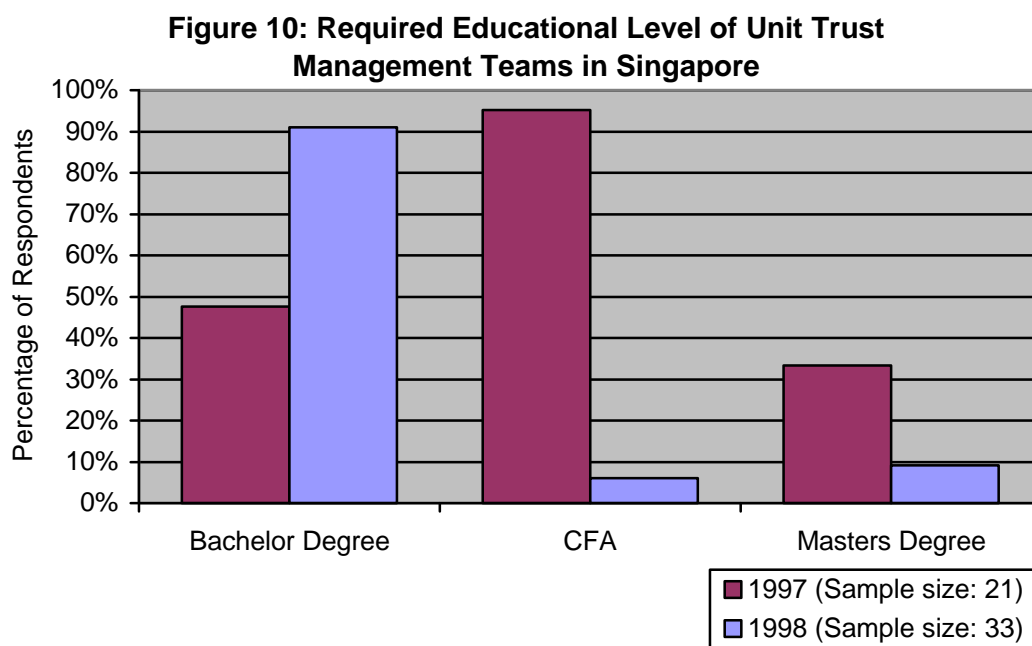
5.3 Regulatory Risks

With the liberalization of the financial sector, regulatory risk has increased in importance in Singapore, according to the responding unit trusts. Of 40 respondents, 33 (82.5%) considered regulatory risk important as compared to only 40% (out of 5 respondents) in the first survey in 1996. Eighty-five percent anticipate changes in local regulations, and all of them said that they are proactive in doing so.

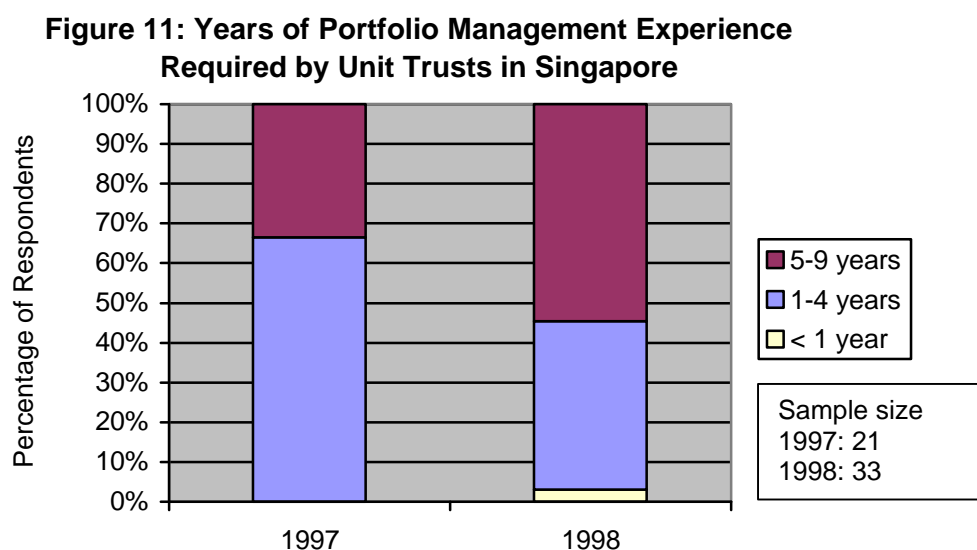
5.4 Human Factor Risks

To reduce human risk, 30 (93.8%) out of 32 of the respondents separated the unit trust teams into different functional areas. However, such efforts could be undermined by the absence of a mid-offices, as close to half of the respondents revealed that they do not have a mid-office to control information flow between the front and back office. Or, more likely, their fund management operations are still too small to require such a facility.

In terms of qualification requirements, Figure 10 shows that in 1998 a majority of the unit trusts required their managers to have earned at least a bachelor degree, instead of a CFA qualification, as required by the majority of unit trusts last year. This is probably an adjustment of initially unrealistic expectations regarding the potential passing rates for the required three consecutive CFA exams, administered by the AIMR.



Possibly induced by the Asian Financial Crisis, there was an increase in the percentage of unit trusts requiring at least five to nine years of experience from fund managers as shown in Figure 11. One of the unit trusts requires managers with less than one-year experience. A possible explanation could be the very limited pool of experienced fund managers in Singapore. New and more experienced expatriate blood is currently brought in for grooming to cope with the current unprecedented expansion of the number of unit trusts.



6. COMPETITION AND REGULATION

In 1998 it became clear that the local authorities would push ahead with financial market liberalization and increase competition by allowing overseas managed mutual funds to be sold in Singapore. In response only one (2.9%) of 34 responding unit trusts felt that it would be seriously affected, in sharp contrast to previous years. This is only a tenth of the 29% reported in the midst of the Asian Financial Crisis in 1997. Both in 1997 and 1998 it was said that the sales and marketing efforts would be hardest hit from the increased competition, but not how.

In 1998 of 15 respondents, 14 (93.3%) preferred disclosure-based, market enforced self-regulation. Only one preferred merit-based regulation by securities authority. In comparison, in 1996 the responses had been evenly divided. Table 5 describes the two systems of regulation. Comparing the pros and cons of the two regimes, it is apparent

why the 1998 respondents prefer disclosure-based regulation. Currently, Singapore still has a mixture of both regimes.

Table 5: Let the Investor Beware

<p>Disclosure-based regime: Acknowledges that the market is better able to decide on the merits of a transaction than the regulator. Investors take responsibility for their own investment decisions.</p> <p>Pros:</p> <ul style="list-style-type: none">◆ Transactions do not suffer from delays caused by the approval process.◆ Promotes business and financial innovation since companies are not slowed down by regulatory requirements.◆ Greater investment choice.◆ Increased liquidity. <p>Cons:</p> <ul style="list-style-type: none">◆ Investors are not protected against making poor investment decisions. <p>Merit-based regime: New listings, transactions and disclosure reviewed and decided by securities regulator on the basis of their perceived merits.</p> <p>Pros:</p> <ul style="list-style-type: none">◆ Investors protected to some degree as regulator sieves out some problem areas and assesses risk. <p>Cons:</p> <ul style="list-style-type: none">◆ Delay, loss of business efficiency, flexibility and missed opportunities because transactions need clearance on case-by-case basis.◆ Securities regulator may not necessarily be in a position to verify information.◆ Discourages personal responsibility and self-reliance.

Straits Times 27 May 1998, "Move Forward With Disclosure-based Rules".

6.1 Private Industry Association IMAS

Contrary to the results of the preceding two years, an overwhelming 36 (97.3%) of 37 respondents in this year's survey consider the newly registered Investment Management Association of Singapore (IMAS) a suitable private body for the setting of ethical guidelines and standard practices. In inimitable Singapore style, a former MAS official, Mrs. Elizabeth Sam chairs this private body.

The only respondent who felt otherwise stated that a public body should shoulder the responsibility. One reason could be that that manager felt that the interest of the general public is not adequately represented, or perhaps, that there is lack of enforceability for any standards or guidelines set by the Association. However, private investment management associations, like the AIMR in the USA, have shown that market-based rule, combined with public censure and possible withdrawal of Charters provides very effective enforceability and adequate protection of the public

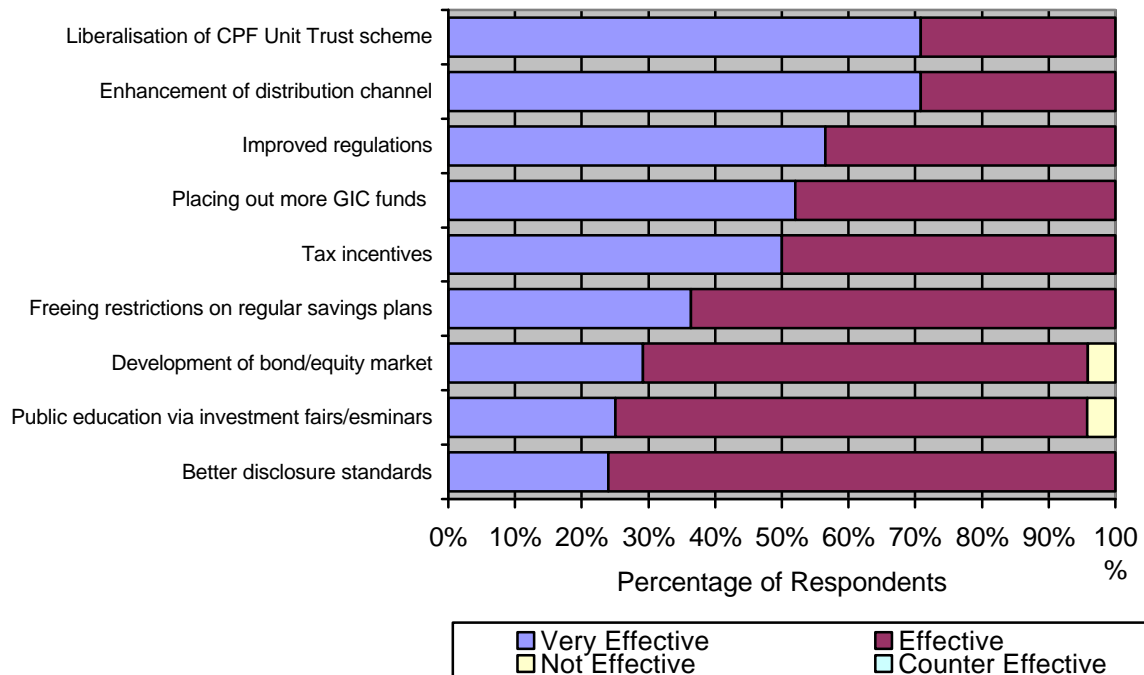
interests. This is especially so when such private actions are in line with elementary Investment Advisory Services laws, such as enforced by the Securities and Exchange Commission, to protect the interests of the small investors.

6.1 Perceived Effectiveness of Government Strategies

Figure 12 shows how the respondents rated the effectiveness of the various strategies proposed and implemented by the Government to develop the local unit trust industry. The majority, 17 (68%) of the 25 respondents found that the liberalization of the CPF Unit Trust scheme, together with the enhancement of the distribution channels, would be (very) effective government strategies to develop Singapore into a premier fund management center in Asia. Placing out more GIC funds and improved regulations closely followed this.

With regard to public education, one respondent said that it was not effective as a strategy due to still low penetration. One respondent also indicated that the development of the bond and equity markets is ineffective, and this could be attributed to the fact that the local retail markets in Singapore are still too small.

Figure 12: Perceived Effectiveness of Government Strategies in Singapore to Promote the Unit Trusts



6.3 Impact of the Asian Financial Crisis

When asked how they view the Asian Financial Crisis, an absolute majority of 70.4% of the 27 respondents indicated that the turmoil is a time to pick up sound stocks at bargain prices, while 11.1% feel that it is a time to pull out of Asian markets. This is an encouraging sign as it reflects that most funds are cautiously optimistic that Asian markets will recover and that Asia still has good investment potential. But, there are also funds, which commented that the turmoil is a time to adopt a more defensive strategy by maintaining higher cash weightings. Because of this financial turmoil, 17 (60.7%) of 28 respondents have changed their unit trust's cash allocation. All the 12 funds that responded to the second part of this question increased their cash allocation, which ranged between 5% and 50%.

7. CONCLUSIONS

Unit trusts in Singapore showed in 1998 more diversification outside of Asia than in the two years before. This was doubtlessly induced by the Asian Financial Crisis in the fall of 1997. Also, the Singapore authorities have removed virtually all constraints on foreign investments by their unit trusts. But the Asian Financial Crisis and the increased competition had not dampened the enthusiasm for unit trusts. In the fall of 1998, many Singapore unit trusts considered it already an opportune time to bargain hunt for "sound value" in Asia. However, one of the biggest problems facing investors in Asia is the pernicious lack of information on which to base the valuation of assets.

There is an improvement in the standards of risk management practice since this survey was first taken three years ago. The survey's base has broadened from 79 in 1996 to 158 in 1998, while the response rate has successfully increased from 11.4% to 25.9%, respectively. In 1999 a base of more than 200 with a response rate of more than 30% is expected. Overall, the quality of the responses has improved and the unit trust managers have been more forthcoming with information about their average asset and sectoral allocations.

The actual disclosure standards of unit trusts in Singapore, while gradually improving, are still low in comparison to those to which private investors are now accustomed in

the USA. One of the most remarkable outcomes of the 1998-Survey was the discrepancy between how much the unit trusts were willing to anonymously disclose about themselves for the purpose of this survey, and how little they actually disclosed to their own unit holders. In the USA sheer competition has driven the mutual funds to disclose their risk exposure and the analysis of their risks and their basic asset and sectoral allocations to their share holders. This is done usually in the form of standardized performance disclosure statements to private firms, which regularly monitor particular universes of mutual funds, e.g. Morningstar, Wiesenberger Investment Companies Services, etc. The Unit Trust Research Unit of CREFS at NTU schedules a similar service in Singapore, on a trial basis, for the year 2000.

The current liberalization of the financial sector in Singapore and the subsequent increased competition is expected to force the unit trusts to improve their distribution channels, to become more user-friendly and to disclose better the magnitude and kinds of risks taken in obtaining their accumulated returns. A further increase in the sophistication of the risk analysis by better-educated and more experienced managers is also expected, with more disclosure of the analysis and managers' background to the unit holders.

In this 1998 Survey the unit trust managers in Singapore expressed a clear preference for disclosure based, market driven regulation by a private industry association. The newly formed Investment Management Association of Singapore is expected to take the lead in the education effort of both the unit trust managers and the investors' public.

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