Suspended funds investor update

An overview from Stewart Brentnall, Chief Investment Officer (CIO), OnePath.

Although we have seen some signs that markets may be beginning to heal, the post-Global Financial Crisis (GFC) environment has been dominated by market swings, political unrest in the middle east, sovereign debt issues in Europe and natural disasters to name a few. Many investors assume that the GFC is behind us, however its wake continues to present an array of challenges - one of the biggest facing Fund Managers and investors alike is the suspension of funds.
Stewart Brentnall shares his thoughts on what triggered the widespread suspension of mortgage funds across the industry and what steps OnePath is taking to assist investors.

When the word 'mortgage' is heard most people immediately begin to calculate how many more payments they have to make until they own their dream home. However, as an investor in the OnePath Mortgage or Income Plus funds, the context is vastly different.

Your investment in the OnePath Mortgage or Income Plus funds via OneAnswer is bundled together with the monies of other investors and then invested in the Mortgage Pool (or the underlying fund) – which invests in assets such as loans secured by mortgages over real property, mortgage-backed securities, cash and other short term fixed interest securities. The Mortgage Pool is made up of a diversified portfolio of approximately 200 loans, across a variety of property sectors and geographical regions. The loan portfolio as at 2 May 2011 was worth $917 million.

These mortgages aim to provide a steady rate of interest return and are conservatively managed through strict lending criteria. As Mortgages are not easily turned into cash, the fund maintains a portion of assets that can be quickly turned into cash to pay expected untiholder withdrawals.

In extraordinary circumstances, where the level of demand for cash withdrawals exceeds the level of cash available, the fund may be forced to suspend all withdrawals. The main driver of this decision is that the selling of assets (including loans) quickly - simply to pay the withdrawal requests - usually does not provide sufficient time to sell the assets at a price which represents appropriate value for investors. I will discuss this more in the next section.

A recap

As you are no doubt aware, in late 2008 the OnePath Mortgages and Income Plus funds were suspended in response to events that occurred as a result of the GFC. One of the more significant events included the Federal Government's decision to provide an unlimited guarantee on bank deposits which resulted in unprecedented levels of withdrawals across the mortgage fund sector. Basically, investors felt that in such uncertain times their investment was 'safer' in a bank account - unfortunately the Government did not anticipate that the flow-on effect would cause such a dramatic increase in withdrawal requests from funds such as mortgage funds. This was coupled with a drop in commercial property values in Australia – a cycle which still does not appear to have reached its low point.

To protect the interests of our investors, we made the difficult decision to suspend withdrawals from and investments into our OnePath Mortgages and Income Plus funds. Suspending the funds meant we have been able to protect the value of existing investments and to ensure any available monies could be released equitably, over time, to all investors.

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The reason we took such drastic action is due to the nature of the funds. A mortgage fund only holds a limited amount of assets in cash which is used to pay withdrawals on a normal daily basis. If a mortgage fund experiences a significant increase in withdrawal requests, then there may be a subsequent shortfall of cash available to meet these withdrawal requests.

By suspending the funds it allowed us to manage the assets in a more orderly manner. If we had continued to pay withdrawals at the accelerated rate we were receiving them, (as many investors sought the security of a bank guaranteed term deposit) we would have been forced to sell the assets of the funds at a 'fire sale' price, in order to meet the withdrawal requests. This would have meant the value of your investment in the fund would have been significantly reduced.

Many other fund mangers are in exactly the same position that OnePath is in with regard to their mortgage funds, or funds that invest largely in mortgages. Some examples include Perpetual, Colonial First State, Challenger and AXA. Their funds are either still suspended and returning capital to investors on a regular basis or they are being terminated.

I do appreciate it is difficult to accept this situation when the end result is that you cannot access your money as you might wish to, but ultimately we are seeking to protect your investment and return an equal portion of every customer's funds to them. In fact, we have a legal obligation to do exactly that – to treat all customers equally. Importantly, the funds have been providing an income return over the period of suspension that is comparable to similar mortgage funds in the market.

Returning capital to you

The objective of the Mortgage Pool (the underlying fund) is to maximise monthly income, and protect investor capital while releasing available liquidity to meet investor needs. OnePath has both a legislative and fiduciary obligation to act in the best interests of all investors. OnePath takes this duty extremely seriously and has a comprehensive process in place to assess on an ongoing basis the strategy of the Mortgage Pool and the quality of assets held.

The portfolio is being managed with a view to returning capital to investors over time hence new loans are not being written and the focus is on managing existing loans. From March 2011 we are no longer offering withdrawal windows as we previously had, whereby investors submitted a request to withdraw from the fund. Instead, we are returning available liquidity to all investors on a pro rata basis. Investors do not need to submit a form - they will automatically receive this payment and the level of these payments is expected to be higher in coming quarters than it has been, since the funds were suspended in late 2008.

With the majority of loans in the portfolio maturing in the next 2 years it is likely that a substantial part of capital will be returned to investors in that period of time, however this will depend on a number of factors. The reason this will take some time is that the loans held within the Mortgage Pool are made over 3 to 5 year periods. The funds are not accessible until the loans are repaid at the end of the loan period. During April 2011 the Mortgage Pool released 8% of funds under management. We are estimating that in July 2011 we will be able to release 9% or higher.

To sum up

Since the suspension, OnePath has been diligently managing the investments of the Mortgage Pool on behalf of investors to ensure it has been able to deliver income returns for investors in line with similar funds in the industry. Please be assured that even though the OnePath Mortgages and Income Plus funds are still suspended we continue to actively manage the investments on your behalf.

Would you like more information?

It is important that you're speaking with your financial adviser about your investment in the suspended fund – they can assist to explain the background, review your financial plan in light of the suspension and make appropriate recommendations to help you to meet your financial goals and needs.

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