

ALL YOU NEED TO KNOW ABOUT...

price spreads



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Graham Bentley
Head of Investment Marketing

Graham Bentley offers further clarity on fund pricing with a masterclass on price spreads.

One of the less obvious effects of market volatility is the impact on the calculation of fund prices, and in particular those of unit trusts. Despite Skandia's radical change to pricing on the Skandia platform, some advisers have been somewhat mystified by the fact that a degree of bid/offer spread remains on these funds, and in some cases is quite substantial. This seems counterintuitive given we have categorically stated there are no funds on the SIS platform that bear the fund manager's initial charge. Having spoken to a number of advisers it became clear that there is a degree of misunderstanding surrounding unit trust pricing and we consequently felt that this month's feature would be best employed by a brief masterclass on fund pricing.

Let's consider the example of setting up a new unit trust – the AnyCo Unit Trust Fund. Using the money of its investors, AnyCo wants to buy a collection of its favoured shares and/or bonds. All securities have a price at which they're offered to investors by the market (the offer price), and a lower price the market will bid for shares if you want to sell them back (the bid price). The difference between the two prices is known as the 'spread', and compensates the market maker for the risk of acting as principal, ie the buyer of last resort.

The size of the spread depends on Normal Market Size. For instance, FTSE 100 companies' shares are very liquid and traded in larger volumes, and more often than smaller companies' shares; the risk that the market maker might be left holding unwanted shares, or being unable to fulfil an order, is minimal. Consequently the spread tends to be narrow. On the other hand a small company with not many shares in issue, and low daily trading volumes, carries much more risk to the market maker and therefore spreads can be significant. Any liquidity risk will tend to widen spreads. Spreads can be as narrow as a few basis points, or as wide as 50% for illiquid stocks in periods of extreme volatility.

pricing the fund

AnyCo will buy those stocks at the quoted offer price, but only be able to sell them back at the quoted bid price. As new investors have to bear the costs of entry into the fund (as opposed to existing investors), and exiting investors are responsible for the costs of redeeming units, the AnyCo fund must have its own offer and bid prices. Furthermore, AnyCo will have to pay a stockbroker to buy the securities, and pay him again if they want to sell shares. Other costs, such as stamp duty on purchases, will have to be included in the calculation of the fund's prices.

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AnyCo Unit Trust Fund

figure 1

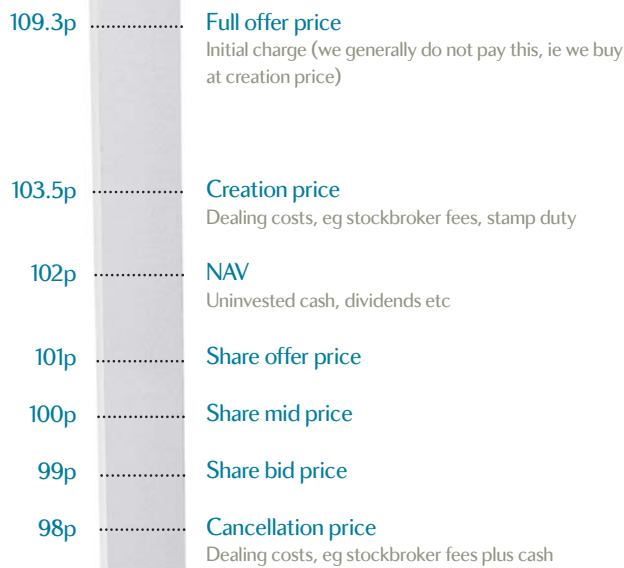


Figure 1 explains how the AnyCo fund might be priced and for the sake of simplicity assumes all stocks have the same price and spread.

The shares the AnyCo fund is buying have a mid price (the one you see in the FT) of 100p, but a spread of just under 2% – the fund is buying them for 101p. An amount is then added to represent any dividends received or cash that is yet to be invested (ie total cash divided by number of units in issue), giving the net asset value (NAV). Next dealing costs will be added, and the resulting price (103.5p in the example) is known as the ‘creation’ price. This is what it costs the fund to create a unit. However, the fund would also like to make a profit so an ‘initial charge’ is added, typically 5.25%. This is important – many people believe the unit trust spread is the initial charge. It isn't – as you can see the charge is part of the offer price calculation. So the maximum offer price on the fund is 109.3p (after rounding).

To calculate the minimum bid price (ie the cost of cancelling units), AnyCo will perform the same calculation in reverse (but still adding cash rather than subtracting it)



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“ At Skandia our aim is to make fund pricing as clear as possible for you and your clients. ”

>> and end up with a cancellation price of 98p. The total spread is almost 11%, and remember that the wider the spread on the stock, the wider the fund spread will be. AnyCo is not able to market a fund at this cost to a client, so has to narrow the spread somehow. Each day at the valuation point buyers will be matched to sellers, whereupon there may be a shortfall (more buyers) or excess (more sellers) of units. If units have to be created to fulfil the excess orders, the maximum offer price will be charged, and the bid price reset at some point below that – say a more sensible 6% less (this can be set anywhere above the cancellation price). This pricing approach is known as offer basis.

If AnyCo wants to sell this fund on Skandia’s platform it will have to do so without an initial charge, ie at creation price or less (see figure 2). Note that despite the discount Skandia receives, there is still a spread remaining and this will be wider where the underlying securities are illiquid or volatile.

Alternatively the AnyCo fund might be a net redeemer and so have to cancel units, not create them. In this instance AnyCo has to set the bid price at cancellation, and provide an offer price at a sensible level above that (figure 3). This is known as pricing on a cancellation basis, and Skandia would buy the fund without an initial charge, again with a spread remaining.

The ‘worst case’ scenario is where investors are uncertain about the fund being net buyers one day but net sellers the next. If the AnyCo fund moves from an offer to a cancellation price basis every other day, the prices will appear very volatile. The solution here is to ‘mid-price’, quoting an offer price that might be too low, with a bid price that may be too high. To compensate for that risk, AnyCo must widen the spread (figure 4).

Note that even though Skandia buys the fund net of the initial charge (ie a 5.25% discount), because the fund spread is wider,

figure 2

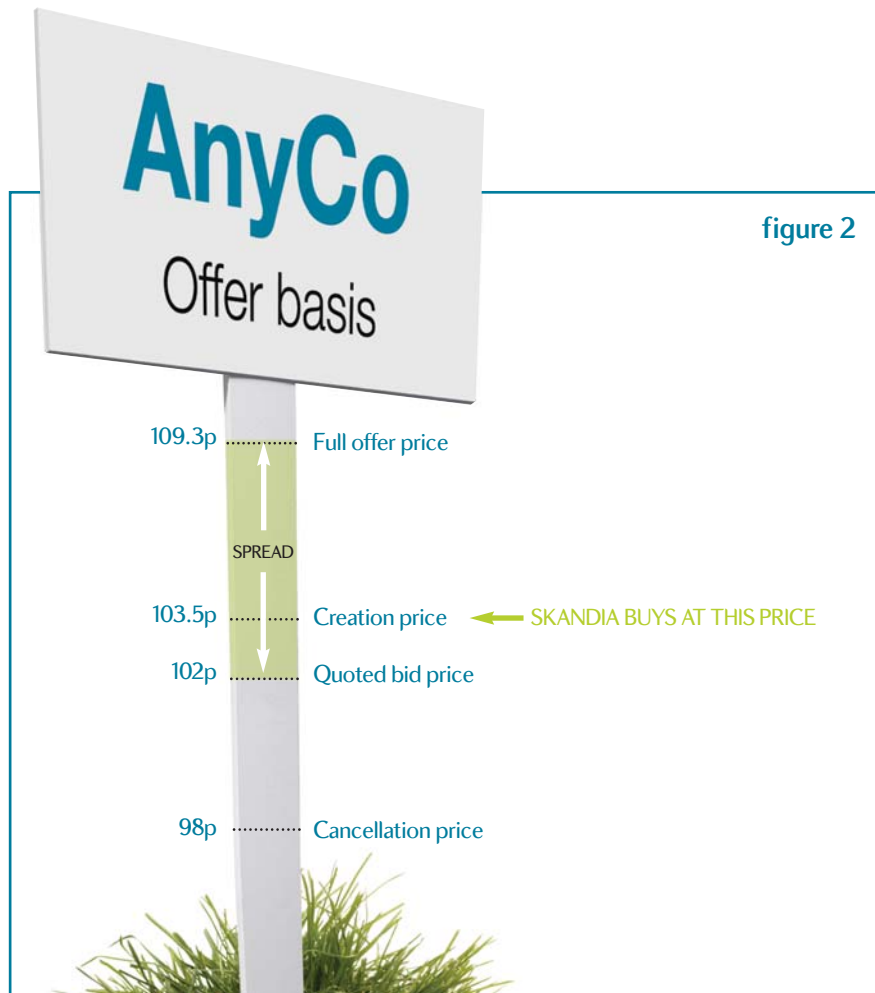
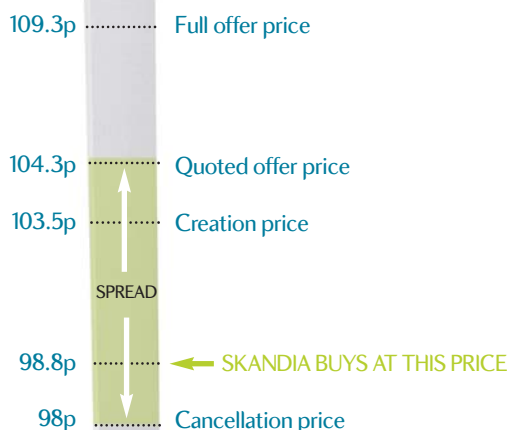




figure 3

AnyCo Cancellation basis



Skandia's investors (and those of any other platform) will still have a 99p bid price as that is the quoted bid, having bought at 101.5, giving a spread of 2.5%. The wider the fund spread, the wider the investors' spread, as the discount is constant.

Clearly this is quite a complicated process for investors to understand. Most funds today are constructed as ICVCs under OEIC legislation that was enacted in 1997. OEICs have only one single price, with the initial charge being taken separately. Having single-priced funds made it easier for UK-based fund management groups to sell their investment funds in Europe. OEIC pricing might imply that there is no bid/offer spread, but it is still there – it is simply included. An OEIC's single share price is effectively the mid-value between the offer and bid prices of the underlying fund. Basis movements can be reflected by applying a factor to handle the dilution effect on the fund, either by charging these dealing costs to the fund (ie to existing shareholders who have nothing to do with these costs) and thus making the single price 'swing' to account for it, or by applying a levy to only those investors leaving the fund (thus protecting the fund price from an adverse impact). In the latter case the dilution levy is displayed as a separate, explicit charge on the contract note.

At Skandia our aim is to make fund pricing as clear as possible for you and your clients. Developments such as our pricing comparison tool (see page 10) help you to make clear choices and fulfil due diligence requirements to easily identify where the true value lies for your clients. ●

figure 4

AnyCo Mid-price basis



If there are topics you would like Graham Bentley to cover in future issues of *informer*, please e-mail informer@skandia.co.uk

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