MUNRO

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Whose rules should determine investment portfolios?

BHP is one of the largest dividend paying companies in the world and its cash flow has been a huge boost to most UK investors in recent years because of its place in the UK stock market indices.

However, because of pressure from hedge funds the company is proposing to drop its primary listing in the UK so that its only main listing will be in Australia. As a consequence, this move if approved by shareholders, means it would no longer be part of the UK indices and therefore all passive funds, and probably the majority of active funds that are benchmarked to UK indices, will be obliged to sell their holdings.

This would have two immediate effects. Firstly, it would deprive UK investors of an enormous stream of income in a world where that is hard to find. The second question is who would buy the stock ejected from UK portfolios? Most Australian investors will already have large holdings in the stock and many portfolios have rules that prevent too large a position in any one stock so the scope for the, relatively, small Australian market to absorb the outflow from London looks limited.

A third, but smaller, aspect is that the removal of such a large company from the UK indices would have the effect of increasing the concentration of income from the remaining stocks into an even smaller pool of businesses. As it is now only ten companies account for 60% of the income into the UK stock market.

There is another aspect of rules relating to index construction that this issue raises. Most, but not all indices, have rules on liquidity. Basically, this is just to make life easier for fund managers so that they don't have to chase shares in stocks that are not traded very much because of the existence of long-term holders. This rule also catches companies, like BHP, where a lot of shares are held overseas and, for the purposes of index construction, are ignored from the calculation. This artificially reduces the size of the company in the eyes of UK investors and its status in the index.

This is actually a rather strange approach. When analysing a company and considering, say, its market share we look at the company as a whole, including such matters as its advertising or exploration budget. We don't ignore huge chunks of a company simply because large portions of its equity are held by someone else, or by investors in another country.

In the case of BHP this has a major effect because although only 49% of the shares are listed in the UK, and that figure is used as its weight in the main indices, any portfolio manager that uses fundamental measures will be using data that represents the whole company, i.e., something that is almost twice as big. In other words the traditional market capitalisation UK index weights fundamentally misrepresents the true size of the company. And this issue also applies to the two other companies in the UK with dual listings: Rio Tinto and Carnival Cruise Lines.

Consequently, an index may have a poor correlation with the underlying aspects of the constituent companies and the relative weights may be quite different from those generated by other measures. Index membership and weights are not something that most investors have a choice about. These are determined by index creators who may have different agendas to that of investors.

This leads on to the obvious question of what does an index really represent? Who makes the rules to decide what goes in, what is kept out and how each stock should be weighted? Should all indices just be determined by market capitalisation or is there a role for some fundamental measures to relate positions to the financial attributes of the company. As index investing becomes more widespread these questions will become more important and perhaps shareholders should have a greater say in the matter. Shouldn't they decide which exchanges they want their shares listed on and what measures to use?

Robert Davies

Lead Manager and Business Developer for the VT Munro Smart-Beta UK Fund

VT Munro Smart-Beta UK Fund
Valu-Trac Investment Management Limited. Authorised and regulated by the Financial Conduct Authority (FCA), registration number 145168. Head Office: Orton, Fochabers, Moray, IV32 7QE Telephone : +44 (0)1343 880217 Registered in England No. 2428648 Registered Office: Level 13, Broadgate Tower, 20 Primrose Street, London, EC2A 2EW.
Visit our Website at https://www.valu-trac.com/administration-services/clients/munro/
Direct contact details for Robert Davies: Telephone: 01360 771921 Mobile: 07889 690369