Financial Conduct Authority

Market Study

MS15/2.2

Asset Management Market Study

Interim Report

November 2016

Contents

We are asking for comments on this report by 20/02/2017

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Abbreviations used in this document

ACD	Authorised Corporate Director
AFM	Authorised Fund Manager
AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD	Alternative Investment Fund Managers Directive
AMC	Annual Management Charge
ARF	Absolute Return Funds
AUA	Assets Under Administration
AUC	Assets Under Custody
AUM	Assets Under Management
B2B	Business to Business
bps	Basis points (equal to one hundredth of one percentage point)
CMA	Competition and Markets Authority
COBS	Conduct of Business Sourcebook
COLL	Collective Investment Schemes
D2C	Direct to Consumer
DB	Defined Benefit (pension)
DC	Defined Contribution (pension)
EBC	Employee Benefit Consultant
ESG	Environmental, Social and Governance

ETF	Exchange Traded Fund
EU	European Union
FAMR	Financial Advice Market Review
FUND	Investment Funds Sourcebook
GIPS	Global Investment Performance Standards
GSB	Gold Silver Bronze Morningstar Analyst Rating
HHI	Herfindahl-Hirschman Index
IA	The Investment Association
IGC	Independent Governance Committee
IMA	Investment Management Agreement
ISA	Individual Savings Account
IT	Investment Trust
KIID	Key Investor Information Document
LCIV	London Collective Investment Vehicle
LDI	Liability Driven Investment
MiFID	Markets in Financial Instruments Directive
MiFID II	Markets in Financial Instruments Directive II
MIR	Market Investigation Reference
NURS	Non-UCITs Retail Schemes
OCF	Ongoing Charges Figure
OEIC	Open-Ended Investment Company
OTC	Over the Counter
PRIIPS	Packaged Retail and Insurance-based Investment Products

PRIIPS KID	Packaged Retail and Insurance-based Investment Products Key Investor Document
PRIN	Principles for Business
RDR	Retail Distribution Review
RFI	Request for Information
RFP	Request for Proposal
ROCE	Return on Capital Employed
SIPP	Self-Invested Personal Pensions
SMCR	Senior Managers and Certification Regime
TER	Targeted Expense Ratio
TPR	The Pensions Regulator
UCITS	Undertakings for Collective Investment in Transferable Securities

1. Executive summary

1.1 The asset management industry plays a vital role in the UK's economy. Asset managers manage the savings and pensions of millions of people, making decisions for them that will affect their financial well-being. Asset managers generate returns for their clients by investing clients' money in a wide variety of enterprises, both in the UK and internationally. More broadly, by directing funding to firms they think are most likely to grow, asset managers support businesses that provide jobs and drive economic growth. Asset managers have an important role in the corporate governance of the businesses they fund.

1.2 The UK's asset management industry is the second largest in the world, managing £6.9 trillion of assets. Over £1 trillion is managed for UK retail (individual) investors and £3 trillion on behalf of UK pension funds and other institutional investors. The industry also manages around £2.7 trillion on behalf of overseas clients.

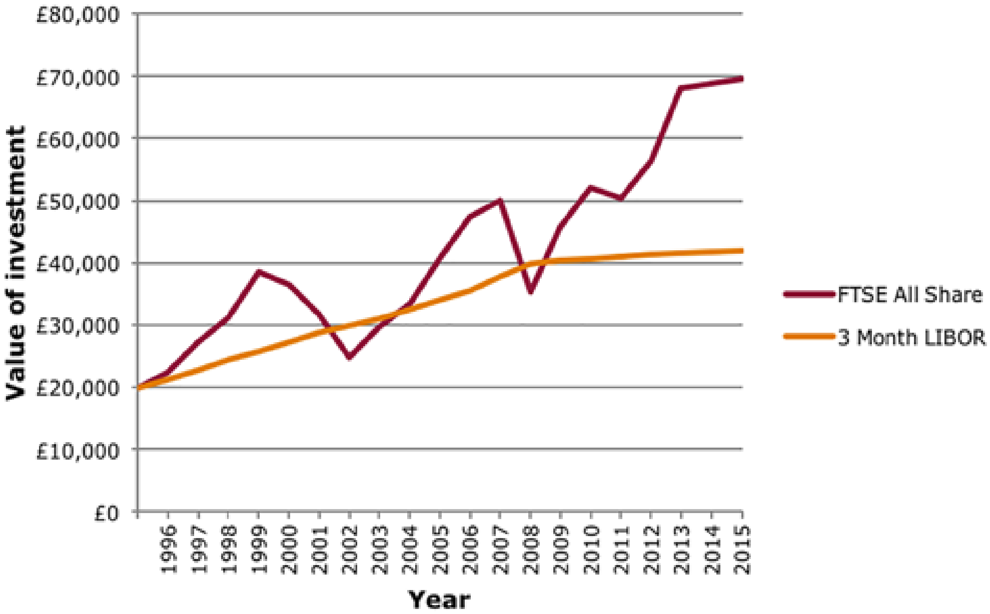
1.3 The service offered to investors comprises a search for return, risk management and administration. The investor bears virtually all the risk. Over three quarters of UK households with occupational or personal pensions[1] use these services, including over 9 million[2] individuals saving for their retirement through defined contribution (DC) pension schemes and over 1.2 million savers currently saving in defined benefit (DB) pension schemes.[3] There are also around 11 million savers with investment products such as stocks and shares ISAs. These investors are willing to put their money at risk to generate greater returns than they can get through cash savings, as illustrated in Figure 1.1.

1 *The contribution of asset management to the UK economy* Oxera (July 2016) www.theinvestmentassociation.org/assets/files/press/2016/The%20contribution%20of%20asset%20management%20to%20the%20UK%20economy.pdf

2 *The Pensions Regulator data based on scheme returns* (1 Jan 2016) (*excludes hybrid DB and DC pension schemes*)

3 *The Pensions Regulator data based on scheme returns* (1 Jan 2016)

***Figure 1.1: Value of a £20,000 investment in the FTSE all share versus cash 1996-2015*[4]**

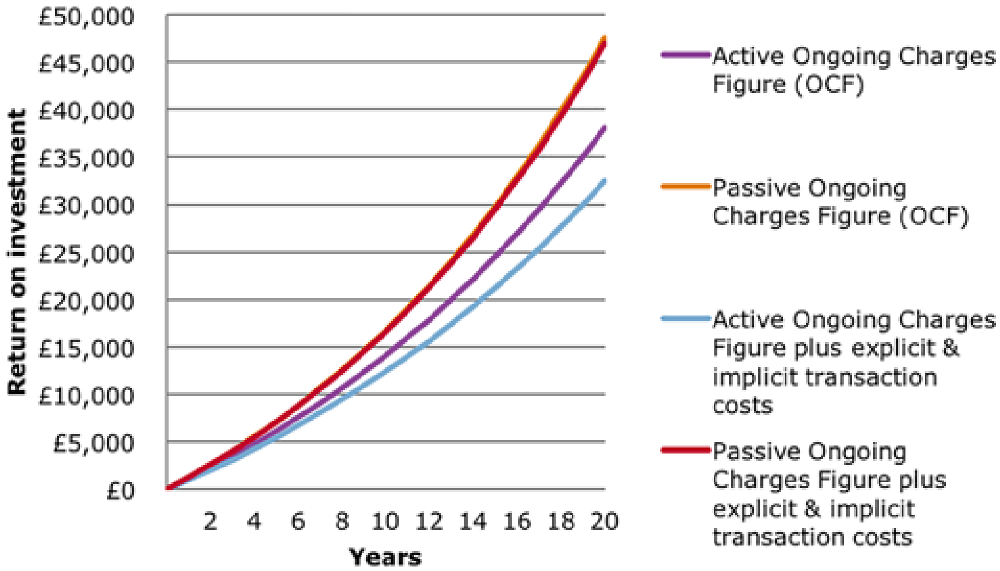


1.4 The FCA has looked at this sector because we want to ensure that the market works well and the investment products consumers use offer value for money. Improvements in value for money could have a significant impact on pension and saving pots. Even small differences in charges can have a significant impact over time.

1.5 Figure 1.2 compares the net return on a £20,000 investment over 20 years to show the impact of charges. Assuming, for illustrative purposes, that both funds earn the same return before charges (the average FTSE all share growth), an investor in a typical low cost passive fund would earn £9,455 (24.8%) more on a £20,000 investment than an investor in a typical active fund, and this number could rise to £14,439 (44.4%) once transaction costs have been taken into account. We recognise that some investors in actively managed funds are likely to expect higher returns in exchange for the greater risk they are taking on.

4 The 3 month LIBOR is the average interbank interest rate at which banks are prepared to lend one another unsecured funds denominated in British pounds. We consider LIBOR to be a proxy for a low risk rate of return available to retail consumers, either directly or through banking saving rates. Equity returns are based on the FTSE all share index inclusive of dividends.

Figure 1.2 – returns on a £20,000 equity fund over 20 years assuming average FTSE all share growth [5]



1.6 We launched this market study in November 2015 after stakeholders raised a number of concerns which we also identified in other FCA work.[6] In order to assess how asset managers compete to deliver value for money, we asked the following questions:

- How do investors choose between asset managers? We outline our findings in Chapter 4
- How do intermediaries and fund governance bodies affect competition between asset managers? We outline our findings in Chapter 5
- What do prices, profits and performance tell us about how competition is working? We outline our findings in Chapter 6
- Are asset managers willing and able to control costs and quality along the value chain? We outline our findings in Chapter 7
- How do investment consultants affect competition for institutional asset management? We outline our findings in Chapter 8
- Are there barriers to innovation and technological advances? We outline our findings in Chapter 9

1.7 This report presents our interim findings. In it we set out our views on how well competition is working and the resulting outcomes for investors. We also outline some proposed remedies. We are keen to hear what stakeholders think about the issues we have identified.

5 These charge figures represent industry average charges for active and passive equity funds in 2015. Along with average brokerage costs based on 16 firm responses and implicit charges as estimated by ITG and based on 100% portfolio turnover per annum for active and 10% portfolio turnover per annum for passive funds. These charges are for illustrative purposes.

6 FS15/2 Wholesale sector competition review 2014-15
www.fca.org.uk/publications/feedback-statements/fs15-2-wholesale-sector-competition-review-2014-15

1.8 Our interim findings are drawn from multiple pieces of analysis including a profitability analysis which assessed operating margins of asset management firms, an analysis of the charges which are taken out of funds and mandates by asset managers, and econometric analysis to understand the drivers of net flows of funds between asset managers. We also commissioned research into retail and institutional investor decision making and choices.

1.9 Other countries are looking at similar issues.[7] For example, the European Commission is expected to recommend that EU regulators investigate asset management performance and fees.[8]

1.10 This market study complements other FCA work in the asset management sector. In October 2016 we published a consultation paper on transaction cost disclosure[9] in workplace pensions. This is an important step in giving the governance bodies of pension schemes the right information to assess whether scheme members get value for money. The market study has been developed bearing in mind the proposed requirements in the Packaged Retail and Insurance-based Investment Products regulation (PRIIPs).[10] We have previously examined the way the dealing commission regime works, including how asset managers buy research with dealing commissions[11] and we use some of that information in this report. Our interim findings and proposed remedies sit alongside other developments to create a coherent policy package.

Overview of the asset management sector

1.11 Investors have many options when choosing how to invest their money. There are 1,840 asset management firms authorised in the UK.[12] A wide range of asset management products offer investors different combinations of risk and potential rewards. These products can be actively managed, can offer small positions either side of a market benchmark, or can passively track an index by holding securities in proportion to the market. In addition, funds can aim to deliver a better return than conventional passive funds by using alternative weightings (so called 'smart beta').

1.12 Passive funds offer investors similar levels of risk and return as the market. Actively managed funds often offer investors the chance to 'beat the market', albeit with a corresponding risk of underperformance. The difference between an active manager's and market performance (before fees) depends on how far the active asset manager invests differently from the composition of stocks in a market. They can do this by, for example, investing in smaller companies or making larger investments in firms which the manager considers to be undervalued. Since 2005 passive funds have experienced nearly fivefold growth and now represent around 23% of the assets under management in the UK.[13]

1.13 Actively managed funds typically charge higher fees than passive funds, reflecting the higher costs of managing an actively managed fund. The annual average disclosed fee for actively

7 Please see Annex 9: International Comparisons for our assessment of what other countries have done to improve value for money for retail and institutional investors.

8 www.ft.com/content/a9060f50-870e-11e6-bbbe-2a4dcea95797

9 CP16/30, Transaction cost disclosure in workplace pensions (October 2016) www.fca.org.uk/publication/consultation/cp16-30.pdf

10 The European Union (EU) has passed a Regulation on key information documents for packaged retail and insurance-based investment products (PRIIPs). This establishes standard disclosure obligations, including a requirement to disclose transaction costs for those products in its scope. Information about the FCA's understanding of the scope of PRIIPs is set out on the following web page: www.fca.org.uk/firms/priips-disclosure-key-information-documents.

11 DP14/3 Discussion paper in the use of dealing commission regime www.fca.org.uk/publication/discussion/dp14-03.pdf

12 FCA internal data

13 Asset Management in the UK 2015-2016, A summary of the IA Annual Survey (September 2016) www.theinvestmentassociation.org//assets/files/research/2016/20160929-amsfullreport.pdf

managed equity funds available to UK investors is 0.90% of the assets under management (AUM)[14] and the average passive fee is 0.15%.[15] Furthermore, transaction costs (charged when asset managers trade on investors' behalf) are normally higher for active funds (as illustrated in Figure 1.2).

1.14 Both retail and institutional investors can invest through a range of different investment vehicles managed by an asset manager. Institutional investors and wealthy individuals can set up a 'segregated mandate' which means their money will be managed independently of other investors. Alternatively, institutional and retail investors can invest in funds, combining their money with other investors' to increase scale and reduce costs.

1.15 Retail and institutional investors can make their investment decisions with the help of advisers. Investment consultants advise institutional investors on their investment strategy, including how to allocate their money between different types of investment, and help them choose the most appropriate asset manager or fund. Retail investors can pay for financial advice to help make investments or invest directly with an asset manager or through a platform (a 'one stop shop' for those who want to compare different funds).

Our findings in summary

1.16 **The evidence suggests there is weak price competition in a number of areas of the asset management industry. This has a material impact on the investment returns of investors through their payments for asset management services.**

1.17 There is a range of evidence underpinning this finding, relating to how asset managers compete, investor behaviour and the role of intermediaries in helping investors choose products.

How asset managers compete

Price trends, charging practices and profitability

1.18 Our analysis shows mainstream actively managed fund charges have stayed broadly the same for the last 10 years.[16] Very few asset management firms told us they lower charges to attract investment, particularly for retail investors – most believe this would not win them new business.

14 Asset-weighted average Ongoing Charges Figure for clean share classes of active equity funds

15 Asset-weighted average Ongoing Charges Figure for clean share classes of passive equity funds

16 After taking account of the effect of the Retail Distribution Review. The Retail Distribution Review aimed to realigned adviser and platform incentives with those of consumers' by removing the commission they received from providers. This has resulted in the 'unbundling' of prices to remove the commission payments to advisers and intermediaries.

Figure 1.3: Trends in the asset-weighted OCF for active share classes over time

Source: OCF data and information about the fee structure of share classes from a sample of asset managers enriched with information from Morningstar Direct. AUM data from Morningstar Direct.

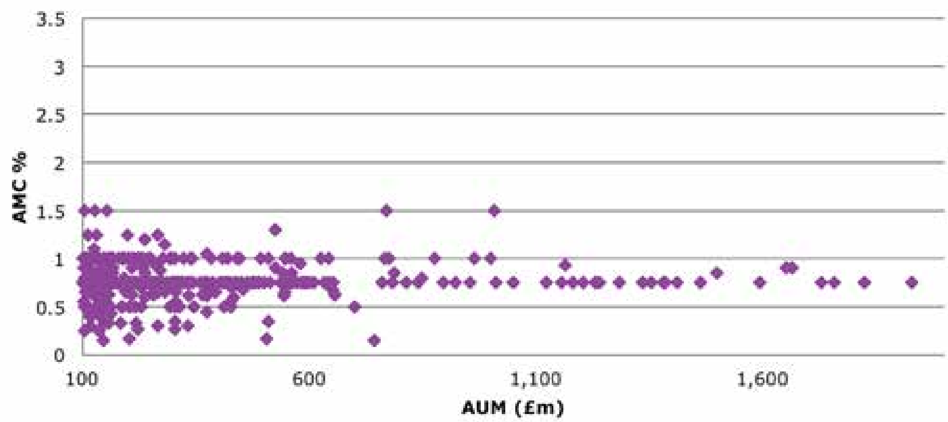
1.19 In contrast, we found that charges for passive funds have fallen over the last five years. This, combined with the growth of passive investing, suggests that price awareness and competitive pressure on price is building among certain groups of investors.

Figure 1.4: Trends in the asset-weighted OCF for index-tracking share classes over time

Source: OCF data and information about the fee structure of share classes from a sample of asset managers enriched with information from Morningstar Direct. AUM data from Morningstar direct.

1.20 We have found considerable price clustering for active equity funds, with many fund priced at 1% and 0.75%, particularly once assets under management are greater than around £100m (see Figure 1.5). This is consistent with firms' reluctance to undercut each other by offering lower charges. We also note that as fund size increases, price does not fall, suggesting the economies of scale are captured by the fund manager rather than being passed onto investors in these funds.

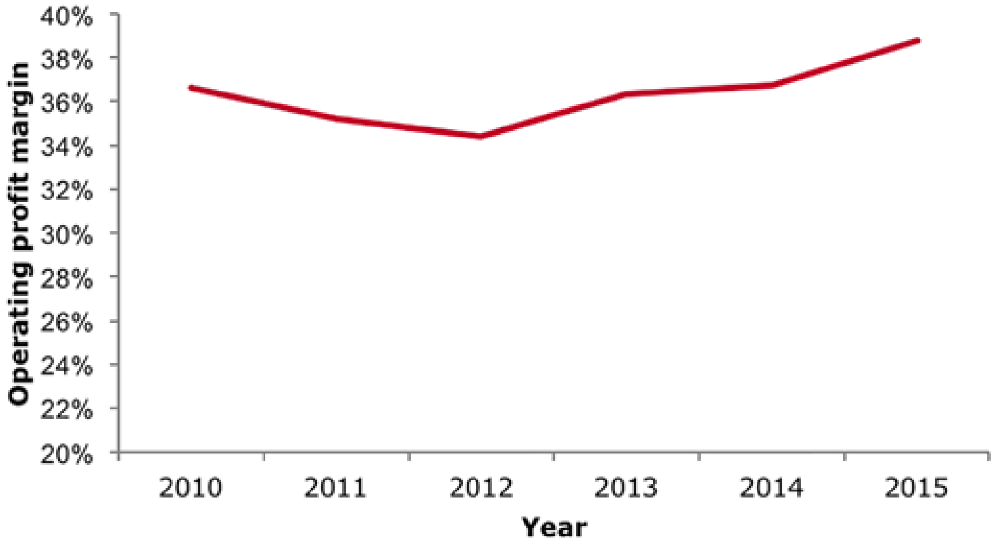
Figure 1.5: The distribution of AMC against AUM for equity share classes



Source: AMC data from a sample of asset managers enriched with information from Morningstar Direct. AUM data from Morningstar Direct. Data for clean equity share classes in December 2015.

1.21 Asset management firms have consistently earned substantial profits across our six year sample, with an average profit margin of 36%. These margins are even higher if the profit sharing element of staff remuneration is included.

Figure 1.6: Average operating profit margin

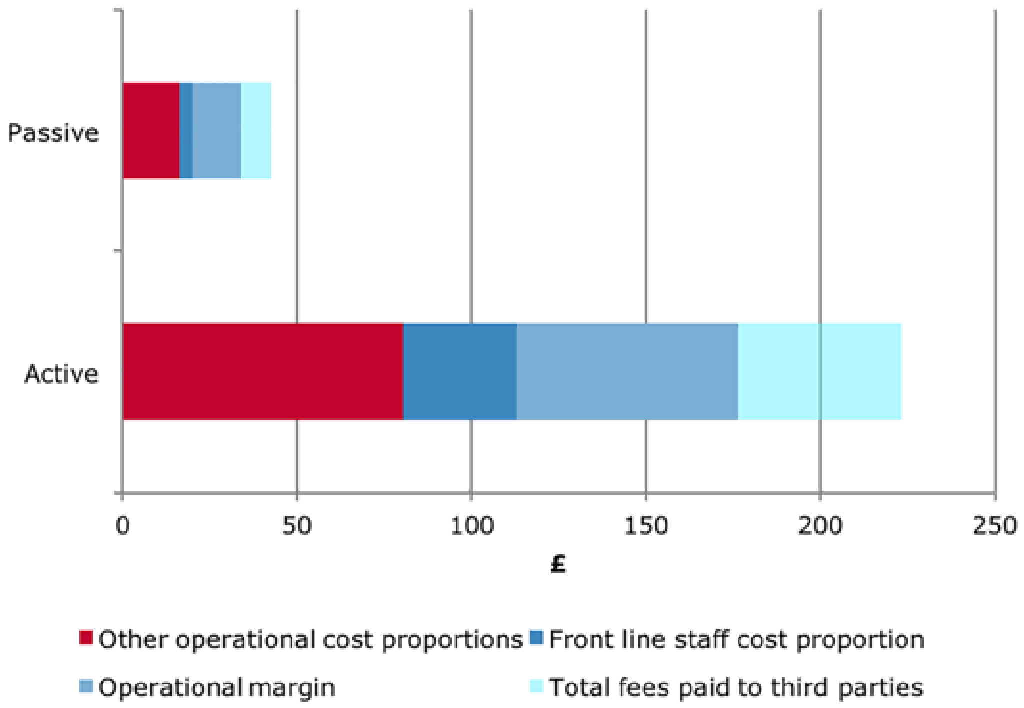


Source: FCA analysis based on financial data submitted to the FCA from 16 firms.

1.22 In many markets, weak pressure on price is associated with weak cost control. We found the evidence on cost control in this market to be mixed. Asset managers tend to be good at managing charges which are straightforward and inexpensive to control, for example, negotiating fees down for services such as safekeeping of assets and many other ancillary services. However, they are less good at controlling costs for services where it is more expensive to monitor value for money, such as how well executed trades and foreign exchange transactions are. Fund governance bodies also do not exert significant pricing pressure by scrutinising asset managers' own costs.

1.23 We would expect the costs of active asset management to be higher than the cost of managing a passive fund. Comparing the total charges made on the fund for actively managed and passive funds, we see that on average both costs and profits are higher in absolute terms for actively managed products.

Figure 1.7 – Average fund charges for 1 year for a £20,000 FTSE all share equity investment[17]



Investor outcomes

1.24 We looked at the relationship between price, performance and how actively the fund is managed.

1.25 Overall, our evidence suggests that actively managed investments do not outperform their benchmark after costs. Funds which are available to retail investors underperform their benchmarks after costs – while products available to pension schemes and other institutional investors achieve returns that are not significantly above the benchmark.[18]

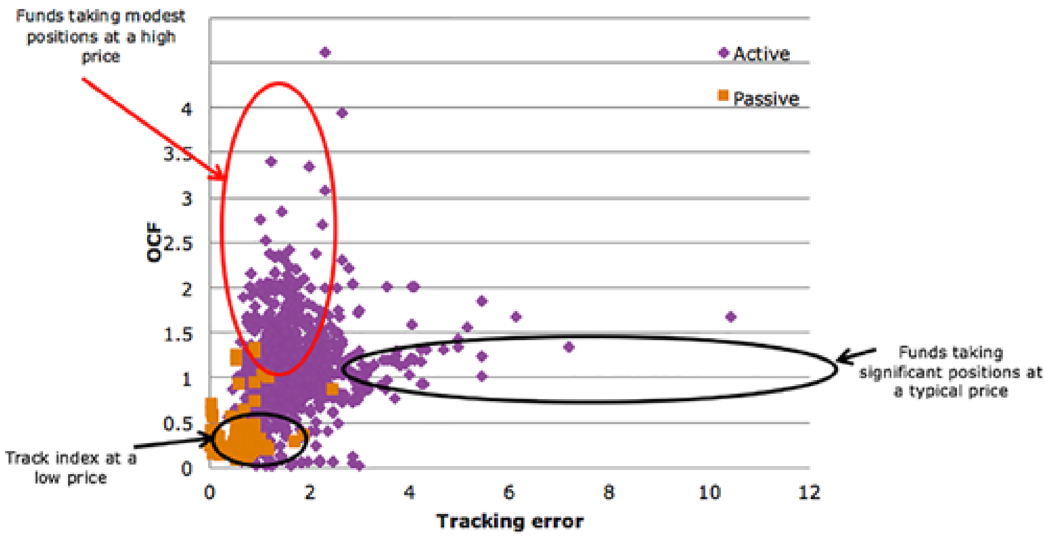
1.26 Investors may choose to invest in funds with higher charges in the expectation of achieving higher future returns. However, we find that there is no clear relationship between price and performance – the most expensive funds do not appear to perform better than other funds before or after costs.

17 Note that this only covers explicit charges. The total charges in Figure 1.7 are higher than the average OCF for actively managed equity funds (0.90 %) and the average OCF for passively managed equity funds (0.15%). This is because the total charge in Figure 1.7 is a money weighted average across the firms in our sample, includes some costs not disclosed in the OCF (such as brokerage costs), and includes asset classes such as fixed income and property funds which are not included in the average OCF equity figures. We assume average returns of 6.43% on active products and passive products, which is calculated as the compound annual growth rate of the FTSE All Share, from 1996-2015. Equity returns are calculated inclusive of dividends where data is available (19 out of 20 years). Dividends are assumed to be reinvested in the index. Charges are based on average active and passive outflows from all pooled funds domiciled or managed and sold within the UK by the 16 firms in our sample. Charges were calculated by applying the annualised average of the FTSE All share index to an investment of £10,000 and then deducting the money weighted average fee of an active and a passive fund based on our sample of 16 firms

18 Our analysis of returns for institutional funds and segregated mandates used ‘manager specified benchmarks’, which is the benchmark chosen by the asset manager to represent the market in which they are investing. Our analysis of fund returns used the Morningstar Category benchmark, which is the benchmark assigned by Morningstar to represent the relevant investment category.

1.27 Many active funds offer similar exposure to passive funds, but some charge significantly more. Figure 1.8 shows the charges (the Ongoing Charges Figure) for active equity funds compared against the 'tracking error'. The tracking error shows the variation of the difference in the returns of the fund against the underlying benchmark. A low tracking error generally indicates that the fund is closely replicating the benchmark, although it may be seeking a small outperformance against this or trying to limit underperformance. There is around £109bn in expensive funds that closely mirror the performance of the market (they have a tracking error below 1.5) and are considerably more expensive than passive funds.

Figure 1.8: Tracking error against OCF for clean equity share classes over 2013-15



Source: Returns and benchmark data provided by Morningstar Direct. OCF data from a sample of asset managers, enriched with information on charges from Morningstar Direct.

Transparency and clarity of objectives and investment outcomes

1.28 The transparency of charges has been under scrutiny and debate for some time. Some progress has been made in this area, including the introduction of the Ongoing Charges Figure, the current FCA consultation to introduce a standardised methodology to calculate transaction cost for defined contribution workplace pensions and work to unbundle research and dealing commission. Industry and investor groups continue to advocate greater transparency from asset managers.

1.29 We found the prices for ancillary services – such as administration, record keeping and services to safeguard the assets – bought by asset managers are usually clear to investors. This is because they are included in the ongoing charges figure for investors using funds, or the investment management agreement for investors using segregated mandates. However, investors are not given information on transaction costs in advance, meaning that investors cannot take the full cost of investing into account when they make their initial investment decision. These costs can be high and add around 50bps on average to the cost of active management for equity investments.

1.30 In addition, we have concerns about how asset managers communicate their objectives and outcomes to investors. Investors may continue to invest in expensive actively managed funds which mirror the performance of the market because fund managers do not adequately explain the fund's investment strategy and charges.

1.31 Absolute return funds are funds that aim to deliver a positive return, whatever the market conditions. We have two concerns with absolute return funds. First, many absolute return funds do not report their performance against the relevant returns target. For example, an absolute return fund may be failing to achieve its performance objective of beating a cash benchmark by 2%. But these funds show their performance against a cash benchmark only, giving the impression that they have outperformed. Second, we have concerns about absolute return funds that charge a performance fee when returns are lower than the performance objective the fund is aiming to achieve. The manager is rewarded despite not achieving what the investor considers to be target performance.

Investor behaviour

1.32 We looked at the factors that drive retail and institutional investors' choice of asset manager (both when making initial investment decisions and when deciding whether to switch between providers). We also examined their ability to negotiate with asset managers.

Factors that drive investor choice

1.33 The investor community is a diverse mix of individuals and institutions. However, we found broad agreement that value for money for asset management products is seen as a combination of the:

- return achieved
- price paid
- risk taken
- quality of any additional services provided by the asset manager

1.34 This means that most investors generally think of value for money as risk-adjusted net returns.

1.35 We found that a key focus for retail investors and, to some extent, institutional investors when choosing between asset managers is past performance. However, past performance is not a good indicator of future risk-adjusted net returns for two main reasons.

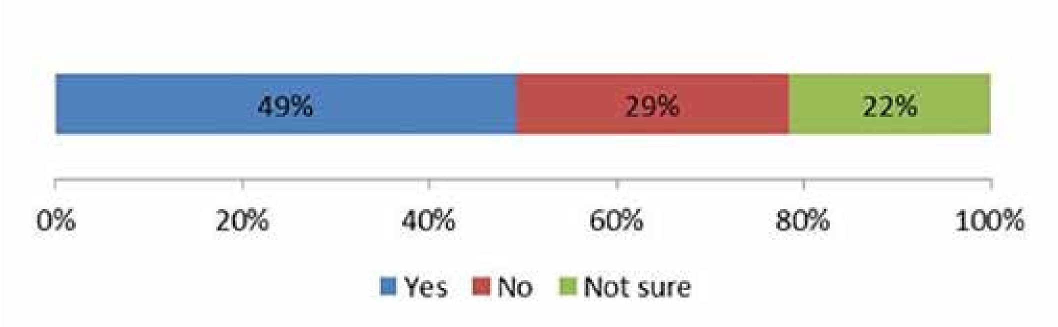
1.36 First, it can be difficult to interpret and compare past performance information. Funds set up at different times will measure performance over different time periods, which can make comparison difficult. The performance of one fund might be measured more frequently than another,[19] which can affect the perceived volatility of the fund's performance, especially over periods of volatility in the relevant market. Funds that perform poorly are often liquidated or merged into another fund, giving investors the false impression that there are few poorly performing funds on the market.

1.37 Second, even if past performance were easier to interpret and compare, past performance has limited value as an indicator of future performance. The academic literature shows little evidence of persistence in outperformance. In other words, managers that outperform in one year do not reliably outperform in future years. Previous UK analysis has found that the majority of funds with historical outperformance do not continue to outperform the relevant market index or peer group for more than a few years. The evidence on persistence in underperformance is less clear, partly because of the impact of fund mergers and closures as discussed below.

19 While the KIID requires fund managers to display performance yearly, other sources of information can measure performance more frequently

1.38 The evidence on investor focus on charges is mixed. There is increasing attention among institutional investors to the level of charges that they pay, as reflected in the demand for greater transparency around costs as discussed in paragraph 1.30. On the retail side however, around half of the investors in our survey were not aware they were paying fund charges.

Figure 1.9 – Do you pay fund charges on your most recent investment product?



Source: NMG Consumer Research (2016)

Switching

1.39 For competition to work effectively, investors need to be able to assess whether their products have delivered value for money and switch if alternative products are likely to better meet their needs.

1.40 Investors can incur a range of costs if they switch between funds and asset managers. The costs include explicit charges, tax and the time and effort it takes to switch between funds. Investors may also be reluctant to switch if it would involve crystallising a loss or cutting short a recommended holding period. Moreover, it is often difficult for investors to know whether they would be better off switching providers. In some cases we have found retail investors remaining in persistently poor performing funds.

1.41 Studies based on US and UK data suggest that there are more funds that persistently underperform their market benchmark than would be expected in a competitive market. Our initial analysis of equity funds available for sale in the UK shows some persistent poor performance. These data also showed that 35% of equity funds which performed poorly over 2005-2010 subsequently closed or merged over 2011-2015. We are undertaking further analysis to understand the implications of fund closures and mergers on the outcomes for investors. We welcome views from stakeholders on this.

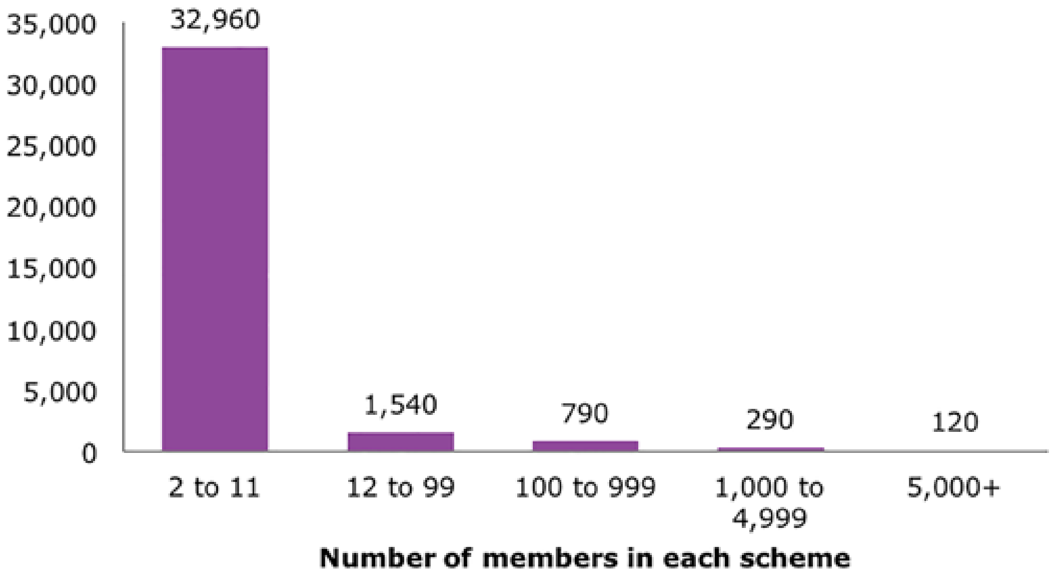
1.42 Asset management firms told us that where they create new share classes (typically in response to the Retail Distribution Review[20]), they find it difficult to switch investors to these new, cheaper share classes even if this would be in the best interests of existing investors. This is because they currently need the investors' consent to transfer them to alternative share classes and many investors do not respond to communications.

Ability to negotiate

1.43 Retail investors do not usually negotiate directly with asset managers and our evidence suggests that fund governance bodies acting on their behalf do not typically focus on value for money. On the institutional side, there are a large number of small pension schemes and trustees which vary in how effective they are at negotiating price.

20 The Retail Distribution Review required firms to move to stop paying commission to distributors, resulting in firms moving to 'unbundled' shareclasses whereby commission payments are stripped from headline fees.

Figure 1.10: Number of defined contribution trust-based pension schemes[21]



1.44 Trustees of pension schemes, and other types of oversight committees that oversee institutional investments, face a range of challenges in their role and their dealings with asset managers. These include low and variable levels of investment experience on the committees and resource constraints.

1.45 We found that there is a relationship between some of the challenges facing oversight committees and their size, with smaller schemes (in terms of assets under administration and the number of trustees), generally being less well-resourced and knowledgeable. The amount of assets also affects oversight committees' bargaining position, with smaller schemes being less able to secure discounts from asset managers. It is likely that smaller pension schemes could achieve significant cost savings from consolidating their assets.

1.46 However, there are challenges and incentives that work against consolidation. Even within a single employer, amalgamating schemes with different objectives and funding levels is challenging and can be costly in the short term.

The role of intermediaries

1.47 We looked at whether intermediaries help investors identify good asset managers and the impact intermediaries have on competition between asset managers.

Retail intermediaries

1.48 There are tools available to retail investors – such as best buy lists and fund ratings – which aim to help investors identify the best funds. Best buy lists in general use a mix of quantitative and qualitative factors, including an assessment of the fund's research practices, investment processes and performance track record. In recent years, the best buy lists for retail investors who invest through a platform have helped investors find funds that perform better than funds

21 The Pensions Regulator DC trust: a presentation of scheme return data 2015-2016 www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2016.aspx#s21422

not on the list. However, we note that after costs even these funds have not outperformed their benchmarks.

1.49 Retail investors do not appear to benefit from economies of scale by pooling their money together through direct to consumer platforms. We also have concerns about the value provided by platforms and advisers and are proposing further FCA work in this area.

Investment consultants

1.50 Investment consultants rate asset managers and we found their ratings do influence which asset managers institutional investors choose. While investment consultants' due diligence means that institutional asset managers are likely to meet minimum quality and operational standards, we have found that these ratings do not appear to help institutional investors identify better performing managers or funds.

1.51 In addition, whilst larger institutional investors are able to negotiate effectively with asset managers, investment consultants do not appear to help smaller institutional investors negotiate or otherwise drive significant price competition between asset managers.

1.52 The investment consultancy market is relatively concentrated, with the top three firms accounting for around 60% of the market. Levels of switching in the market are low – 90% of the investors in our survey had not switched consultant in the last 5 years. Moreover, many institutional investors struggle to monitor and assess the performance of the advice they receive and whether investment consultants are acting in their best interests.

1.53 We have concerns about whether the interests of investment consultants are in line with investors' interests. Investment consultants are expanding into fiduciary management.[22] Fiduciary management is a combination of advice, governance and carrying out investor instructions. This means these consultants are both distributors for – and competitors to – asset managers. We also found that investment consultants accept hospitality from asset managers, such as concerts and sporting events. We consider that this poses a further conflict of interest and could result in poor outcomes for end investors.

1.54 We think further investigation is therefore needed which is why we are consulting on making a market investigation reference to the CMA on the investment consultancy market.

Conclusion

1.55 Together, these interim findings raise a series of concerns about how effectively competition drives value for investors in the asset management sector. We believe there is room for improved outcomes in both the institutional and retail parts of the market. However, our evidence also suggests that competitive pressures are building in some parts of the market and stakeholders and commentators suggest this is likely to continue.

1.56 With more effective competition, we would expect to see investors being better able to find the best investment product for them at a reasonable price. Actively managed funds may be a good investment for investors who prefer the associated risk exposure and, where relevant, the chance to outperform the market. They may also be a good option for investors who want to invest in markets where there is no passive alternative. We want these investors to be aware of

22 The exact terms of the fiduciary management agreement will be mandate specific but typically the fiduciary manager may accept responsibility for the selection of underlying asset managers and may have discretion to deviate from the original asset allocation decision specified by the client.

the risks they are taking on and to pay a competitive price. For those investors seeking market exposure we want them to invest in an appropriate fund at a competitive price.

1.57 Therefore, we propose a package of remedies to boost competitive pressure for both retail and institutional investors and ensure a minimum level of protection for investors. This should also increase the efficiency of the asset management industry and its attractiveness to international and domestic investors.

Interim proposals on remedies

1.58 We have identified several ways in which asset management products and services could work better for retail and institutional investors. We are now keen to hear from stakeholders as we develop a package of remedies to address the issues we have found. In particular, we are provisionally proposing:

- **a strengthened duty on asset managers to act in the best interests of investors**, including reforms that will hold asset managers accountable for how they deliver value for money, and introduce independence on fund oversight committees
- **introducing an all-in fee** approach to quoting charges so that investors in funds can easily see what is being taken from the fund
- helping retail investors identify the best fund for them by:
  - **requiring asset managers to be clear about the objectives of the fund** and report against these on an ongoing basis
  - **clarifying and strengthening the appropriate use of benchmarks**
  - providing tools for investors to **identify persistent underperformance**.
- making it easier for **retail investors to move into better value share classes**.
- requiring **clearer communication of fund charges** and their impact at the point of sale and in communication to retail investors.
- requiring **increased transparency and standardisation of costs and charges** information for institutional investors.
- exploring with government the potential benefits of **greater pooling of pension scheme assets**.
- requiring greater and **clearer disclosure of fiduciary management fees and performance**.
- consulting on whether to **make a market investigation reference to the CMA on the institutional investment advice market**.
- recommending that **HM Treasury also considers bringing the provision of institutional investment advice within the FCA's regulatory perimeter**.

1.59 We also propose further FCA work on the retail distribution of funds, particularly on the impact that financial advisers and platforms have on value for money.

1.60 Our overall policy package will bring together a consistent and coherent framework of interventions which will increase the transparency of costs so that those seeking information can get it. It will also provide greater clarity of fund objectives and performance reporting and protections for investors. When we develop this package, we will take account of the outcomes of our consultation on transaction cost disclosure to pension schemes and Independent Governance Committees.

Next steps

1.61 We are publishing this interim report to give all interested parties an opportunity to comment on our emerging thinking and analysis. We appreciate the time and effort which stakeholders have put into this study so far. We hope that this constructive engagement with stakeholders will continue through the next phase.

1.62 We welcome your views on our findings about how competition works for asset management products and services. We also welcome views on our emerging thinking on potential remedies. Please send your comments to assetmanagementmarketstudy@fca.org.uk by 20 February 2017.

2. Our approach

We launched our market study into asset management in November 2015. We explained that we want to understand how competition is working for retail and institutional investors using asset management products and services. Since launch we have:

- issued information requests and received responses from over 50 firms including asset managers, platform providers and investment consultants.
- conducted analysis covering over 20,000 share classes and 30,000 investment strategies.
- met with over 130 stakeholders in a series of round-tables and bilateral meetings.
- gathered views from over 2,500 retail investors and over 100 institutional investors using online surveys and in-depth interviews.

Why did we decide to look into the asset management market?

2.1 We launched our market study into asset management in November 2015, with the publication of the Terms of Reference.[23] This followed feedback from the wholesale sector competition review, which identified areas within the asset management value chain where competition may not be working effectively.[24]

2.2 As part of that work, we identified some potential areas for consideration, based on the feedback received about institutional asset management. These included:

- whether investors find it difficult to monitor asset managers and ensure they are getting value for money
- whether asset managers have the incentive and ability to effectively control costs incurred on behalf of investors, and
- the role of investment consultants and whether there are potential conflicts of interest in the provision of both advice and asset management services.

23 FCA MS 15/2.1 Asset management market study: Terms of Reference www.fca.org.uk/publication/market-studies/ms15-02-1.pdf

24 FCA FS 15/2 Wholesale sector competition review 2014/15 at page 27. www.fca.org.uk/publications/feedback-statements/fs15-2-wholesale-sector-competition-review-2014-15

2.3 Although these issues arose as part of our review of the wholesale sector, we considered that retail customers were also likely to be affected by some of the competition questions raised.

2.4 Given the size of the asset management market, and the long-term nature of investments, even a small improvement in the effectiveness of competition could substantially benefit investors. With the growing shift from defined benefit to defined contribution schemes, the introduction of automatic enrolment and the recently introduced pension freedoms, there are an increasing number of end investors taking responsibility for their own pensions and savings. The choices made by – and on behalf of – these investors can have a significant impact on the future of their investments. So we want to understand how they make these choices and whether competition is working effectively to drive good outcomes for them.

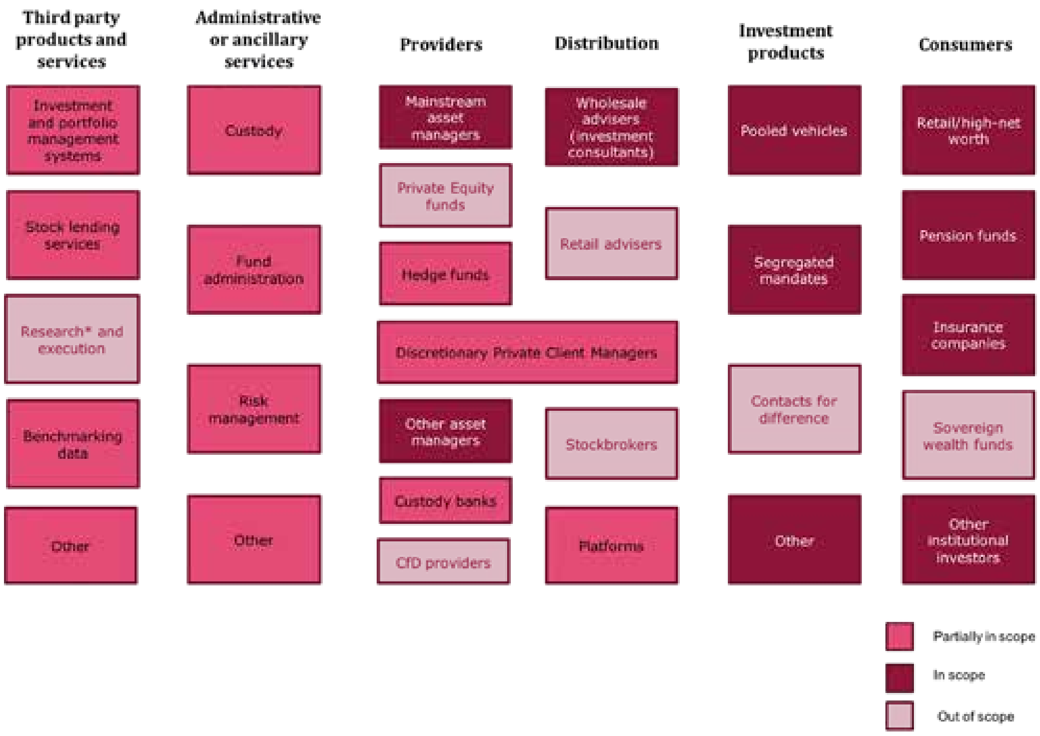
Scope of the study

2.5 The main focus of the market study is on how competition between asset managers is working for retail and institutional investors that use funds and segregated mandates managed in the UK and/or provided and marketed to UK investors.

2.6 We sought views on our Terms of Reference following its publication in November 2015 and respondents were broadly supportive of our intended scope. We summarise the feedback we received in Annex 1.

2.7 To understand how competition works for asset management services, we have looked at related services which affect competition for asset management. For example, we have explored how platform providers and investment consultants affect competition between asset managers, although our in-depth analysis has focused on the role of asset managers. Financial advisers were largely excluded from the scope of this study since the Financial Advice Market Review (FAMR) was ongoing at the time of launch.

2.8 Ancillary service providers are partially in scope of the study. We are interested in understanding how asset managers buy products from these providers particularly where they pay for them out of the investors' money. However, as noted in the Terms of Reference, we did not carry out an in-depth analysis into competition within these areas.



The evidence gathered to support our analysis

2.9 We gathered data from a range of sources. We sent information requests to:

- 37 asset managers, which we selected to ensure a mix of size, businesses models, customer types and strategies. 16 of these firms also received a more detailed financial information request.
- 13 investment consultants.
- 8 platforms.

2.10 We held discussions with over 20 asset management firms, 13 providers of ancillary services, 8 investment consultants, 8 advisers and adviser networks, over 20 other stakeholders and 3 industry groups. We also hosted four roundtables attended by 60 industry participants under Chatham House rule to discuss how competition was working in the retail and institutional markets and whether regulation was creating barriers to competition. We also attended two industry-led roundtables to discuss aspects of the market study.

2.11 We used this along with other information sources, to conduct the following pieces of analysis:

- **Profitability** – We assessed operating margins of asset management firms in our sample at a firm level and split by strategy, client type and asset class. We also estimated the returns on capital employed for the firms. We analysed the relationship between assets under management and costs to determine if the asset management firms benefited from economies of scale. The results of this analysis are in Annex 8.

- **Charges along the value chain –** We calculated the asset management charges for funds and mandates. We estimated the proportion of these charges which is kept by the asset manager and the proportion paid to third parties for services to investors. We analysed this data at a firm level and split by strategy, client type and asset class. We also combined the estimated charges with performance data to see how these charges affect investor outcomes. The results of this analysis are in Chapters 6 and 7.

- **Drivers of fund flows** – We have performed an econometric analysis (using statistical analysis techniques to assess economic issues) to understand what drives net flows of funds between asset managers. We have conducted this analysis to understand which factors investors respond to when making investment decisions. We think these are the factors which asset managers compete with each other to attract investors. This analysis complements the retail and institutional surveys. The results of this analysis can be found in Annexes 4 and 6.

- **Ratings and recommendations value added** – We conducted an econometric analysis to assess whether ratings and recommendations used by investors add value in the investment process. Specifically, we assessed if ratings and recommendations (such as platform best buy lists and ratings given by investment consultants) can identify superior-performing asset managers. The results of this analysis are in Chapter 4 and Annex 6.

- **Adviser incentives** – We analysed if revenue received from asset managers has affected how investment consultants have constructed their ratings and the implications of this. The results of this analysis are discussed in Chapter 8 and Annex 6.

- **Pricing analysis** – We assessed pricing data from a sample of asset managers to understand pricing trends over time, differences in prices between sellers 'price dispersion', and differences in pricing between investor groups. The results of this analysis are in Chapter 6.

- **Investor returns –** We analysed gross and net returns to both retail and institutional investors to understand whether there are systematic differences in the results for different investor groups, and if so, why. The results of this analysis are in Chapter 6.

- **Barriers to effective decision-making by oversight committees of pension funds.** We commissioned academic work to help us understand the dynamics of, and obstacles to, effective investment decision-making by oversight committees. This included a review of economic, behavioural and corporate governance literature. The academic work also involved analysis of an online survey of pension fund trustees and in-depth interviews with market participants. The results of this analysis are in Annex 5.

- **Supervision work on fund governance and dealing commission:** We have used the results of our supervisory work where it provides insights into the questions addressed in this market study.

2.12 We also commissioned 40 in-depth interviews and a survey of 2,500 non-advised retail investors. We wanted to understand how retail investors make choices and review their investment over time (see Annex 3). To understand how institutional investors make their choices, we ran our own online survey with 89 respondents and had one-to-one discussions with 30 institutional investor groups (see Annex 5).

2.13 Our engagement process has indicated a possible lack of awareness of competition law in some areas of the sector, in particular as to how the law applies to commercial relationships and interactions with one another. As an example, information exchange between competitors may be prohibited under competition law if it makes firms aware of their competitors' market strategies. We intend to keep this issue under review as the market study progresses.

Why are we publishing an interim report?

2.14 We want this interim report to give all interested parties an opportunity to comment on our emerging thinking and analysis. We hope this will encourage continued constructive engagement between the FCA and firms, trade associations, consumer bodies, institutional investor representatives and other interested parties.

2.15 Having gathered comments and observations, we expect to publish a final report along with any proposed amendments to our rules by Q2 2017.

2.16 In this report, we set out our initial observations on how competition works for both retail and institutional asset management, highlighting areas where we think that it can work more effectively. We also set out our initial thinking on potential remedies in light of these findings.

Structure of this interim report

2.17 In order to understand how asset managers compete to deliver value, our analysis focused on six core questions:

- **How do investors choose between asset managers?** We analysed how investors choose between asset managers and the implications for how asset managers compete to win business from retail and institutional investors. See Chapter 4.

- **How do intermediaries and fund governance bodies affect competition between asset managers?** We explored the impact investment consultants and platforms have on competition between asset managers and whether fund governance bodies scrutinise value for money on behalf of investors. See Chapters 5 and 8.

- **What do prices, profits and performance tell us about how competition is working?** We explored what prices, profits and performance imply for the way in which competition is working and what the implications are for different investor groups. See Chapter 6.

- **Are asset managers willing and able to control costs and quality along the value chain?** The returns investors receive are affected by the costs and quality of the services that asset managers use. We looked at whether investors can monitor the costs and quality of services they pay for, if these services add sufficient value for end investors and whether asset managers are able and willing to control the costs and quality of the services they buy on behalf of their funds. See Chapter 7.

- **How do investment consultants affect competition for institutional asset management?** Investment consultants play a pivotal role in advising institutional investors on how to allocate their assets and which managers to select. We have looked at how the advice given by investment consultants affects competition between asset managers and what impact it has on the returns for institutional investors. We have examined how investment consultants manage conflicts within their business model and whether clients can monitor the services provided. See Chapter 8.

- **Are there barriers to innovation and technological advances?** We have explored whether there are factors, including regulatory barriers, which prevent asset managers from innovating and improving their technology. See Chapter 9.

3.
Overview of the asset management sector

Around £6.9 trillion of assets are managed in the UK. Of this, over £1tn is on behalf of UK retail investors and around £3tn is on behalf of UK pension funds and other institutional investors. Around £2.7tn is managed in the UK on behalf of overseas clients.

The majority of UK households use asset management services. Approximately three quarters of UK households have occupational or personal pensions and 14% of adults hold stocks and shares ISAs.

Most assets are under active management, with 23% of assets invested passively; but, the proportion which are passively managed has been growing gradually.

The industry is not particularly concentrated, with the largest ten asset management firms operating in the UK accounting for around 55% of total assets under management.

The asset management industry is heavily intermediated. Retail investors are increasingly using platforms to access services. Pension schemes, which represent £2.1tn or 38% of managed assets, need to get advice related to investment matters from qualified advisers with appropriate knowledge and skills. To fulfil this requirement pension scheme trustees tend to seek investment consultant advice on what they should invest in and which asset managers to choose.

Background

3.1 In this section we provide some detail about the asset management industry and its participants, to provide context for the market study.

3.2 Asset managers (also known as investment managers – we use the term asset manager throughout this document) provide an important economic function in bringing together those with money to invest with governments and companies who need capital. Asset managers also act as the representatives of those who own capital and, in this role, can provide oversight and stewardship of the investments they make.

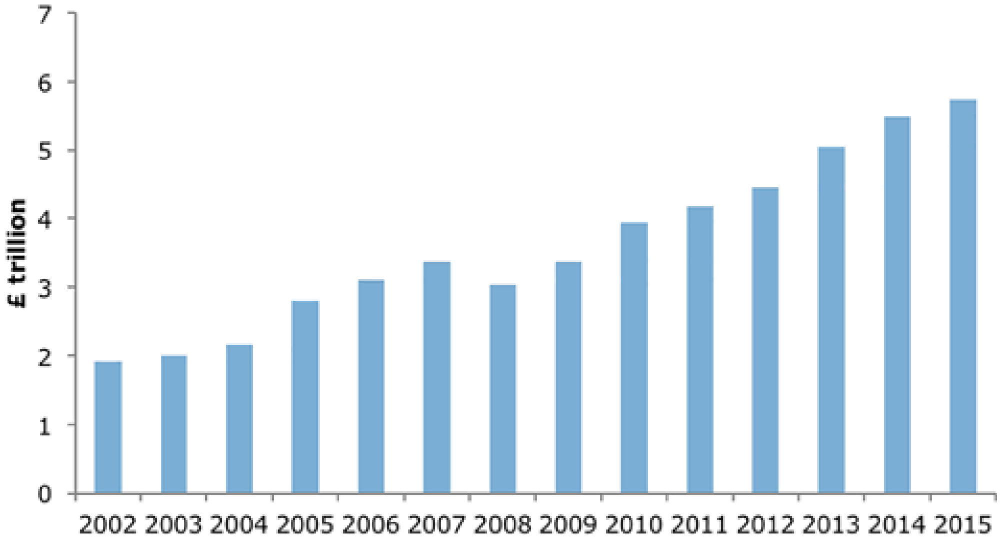
3.3 Asset managers are agents who perform investment management services on behalf of others. This involves two activities:

- making investment decisions on behalf of others
- operating the investment schemes which pool investors' assets and placing them under the control of those who make investment decisions

3.4 In terms of assets under management, the UK asset management industry is the largest in Europe and second only to the US globally.[25] As Figure 3.1 shows, assets being managed by The Investment Association (IA) members have increased year on year since 2008.

3.5 The IA estimates that nearly 40% of assets managed in the UK are for overseas clients.[26] The asset management sector contributes significantly to the UK economy, both in terms of employment and tax revenue. In 2015 the UK asset management industry earned around £17 billion in revenue and generated about 1% of UK GDP.[27]

Figure 3.1: Assets under management in the UK (managed by IA members)



Source – IA figures

There is an estimated further £1tn managed by firms which would not be included in the above data.[28]

25 £6.9 trillion – 2015 figure, *Asset Management in the UK 2015-2016,* A summary of the IA Annual Survey (September 2016) www.theinvestmentassociation.org//assets/files/research/2016/20160929-amsfullreport.pdf, £6.8 trillion – 2014 figure, The City UK www.thecityuk.com/assets/2015/Reports-PDF/UK-Fund-Management-An-attractive-proposition-for-international-funds.pdf.

26 Asset Management in the UK 2015-2016. A summary of the IA Annual Survey (September 2016) www.theinvestmentassociation.org//assets/files/research/2016/20160929-amsfullreport.pdf

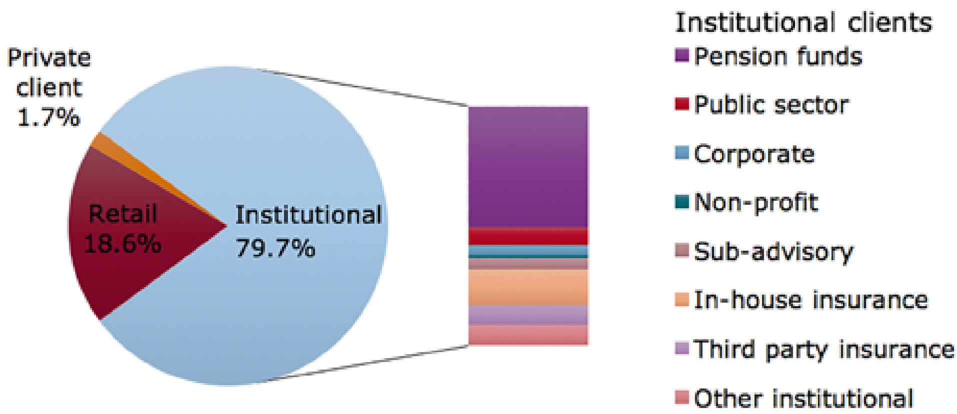
27 Total average industry revenue, which is equivalent to a 6% increase in nominal terms. *Asset Management in the UK 2015-2016*, A summary of the IA Annual Survey (September 2016) www.theinvestmentassociation.org//assets/files/research/2016/20160929-amsfullreport.pdf 1% contribution to GDP is an estimate *The contribution of asset management to the UK economy* Oxera (July 2016) www.theinvestmentassociation.org/assets/files/press/2016/The%20contribution%20of%20asset%20management%20to%20the%20UK%20economy.pdf

28 Based on estimates of the proportion of the part of the total UK market accounted for by non-IA members.

Clients/investors

3.6 As illustrated in Figure 3.2, institutional investors are the largest client type, accounting for nearly 80% of AUM in the UK compared to retail investors who account for less than 20%.[29] Pension funds are the largest single institutional client type with £2.1 trillion of assets under management.[30] The distinction between client types is important as the behaviours, relationships and governance may be different for institutional and retail investors (or within those client types). Institutional investors are more likely to have an individual investment portfolio (segregated mandate) at least for part of their investments, while retail investors are more likely to be invested in pooled funds (where their money is managed alongside other investors').

Figure 3.2: Assets managed in the UK by client type as at end 2015



Source – IA data

3.7 Even though they are labelled as institutional (including in Figure 3.2), the end-beneficiaries of many institutional investments are individual investors. 75% of UK households have occupational or personal pension wealth[31] and defined benefit (DB) schemes still make up the greatest share of pension scheme assets.[32] IA member firms manage £1.5 trillion of DB assets.[33] However, only 13% of schemes were still open to new entrants and future accrual as at December 2015.[34]

29 Asset Management in the UK 2015-2016. , A summary of the IA Annual Survey (September 2016) www.theinvestmentassociation.org//assets/files/research/2016/20160929-amsfullreport.pdf

30 Estimate based on IA and FCA figures. Asset Management in the UK 2014–2015, The Investment Association Annual Survey (September 2015) www.theinvestmentassociation.org/assets/files/research/2015/20150914-ams2014-2015-fullsurvey.pdf This figure includes defined benefit (DB) and some defined contribution (DC) schemes, DC pension assets that are operated via an intermediary platform are reflected in the insurance client data.

31 *The contribution of asset management to the UK economy* Oxera (July 2016) www.theinvestmentassociation.org/assets/files/press/2016/The%20contribution%20of%20asset%20management%20to%20the%20UK%20economy.pdf

32 Defined benefit schemes remove much of the decision-making and risk from the individual investor.

33 Asset Management in the UK 2015-2016, A summary of the IA Annual Survey (September 2016) www.theinvestmentassociation.org//assets/files/research/2016/20160929-amsfullreport.pdf

34 The Purple Book (2015) www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/purple_book_2015.pdf

3.8 Defined contribution (DC) schemes, however, continue to grow – partly due to the introduction of automatic enrolment.[35] The shift from DB pension schemes to DC schemes means that individuals bear more risk and employers bear less. The risk and reward sits firmly with the individual investor in DC schemes. To some extent so does the choice of fund, although support is provided by DC scheme trustees or the employer, for example in selecting the default fund option.

3.9 Retail investors may invest in asset management services through product 'wrappers' (including pension and ISA wrappers). In 2015 14% of the UK adult population held stocks and shares ISAs[36], and during the past eight years the average yearly subscription per account has been higher for stocks and shares ISAs than for cash accounts.[37] In 2015 69% of total stocks and shares ISA value was held in funds[38] and in 2016 the fund and trust holdings in stocks and shares ISA accounts was approximately £172bn.[39]

3.10 Significant numbers of retail investors also access asset management services through personal pensions. There were nearly 15 million policyholders with individual personal pensions at life insurers in 2015.[40]

3.11 Investors may also access products and funds outside a wrapper, either directly or through a platform. In 2015, 5% of households had money held in unit trusts or investment trusts outside of wrappers; totalling an estimated £30bn.[41]

3.12 Retail investors can also get financial advice from advisers who can play a role in both designing and implementing investment decisions.

Asset management firms

3.13 The number of asset management firms currently authorised in the UK stands at 1,840, a 2% increase since 2014.[42] Between 2011 and 2015, at least 750 new asset management firms were authorised that currently remain authorised and active.[43]

35 NAPF Annual Survey (2014) revealed that active membership of DC schemes now outnumbers that of DB schemes for the first time: www.napf.co.uk/PolicyandResearch/Research/Annual-Survey.aspx

36 Based on ONS population statistics and ISA subscription statistics – Population statistics: www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationestimates ISA statistics: www.gov.uk/government/uploads/system/uploads/attachment_data/file/547217/Full_Statistics_Release_August_2016.pdf

37 For example, in the 2015-2016 subscription year the average subscription per stocks and shares account was £8,443 compared with £5,810 in cash ISA accounts. Individual Savings Account (ISA) Statistics HM Revenue & Customs data (August 2016) www.gov.uk/government/uploads/system/uploads/attachment_data/file/547217/Full_Statistics_Release_August_2016.pdf

38 Asset Management in the UK 2015-2016, A summary of the IA Annual Survey (September 2016) www.theinvestmentassociation.org//assets/files/research/2016/20160929-amsfullreport.pdf

39 Market value of holdings as of 5 April 2016, based on HM Revenue & Customs and ONS data

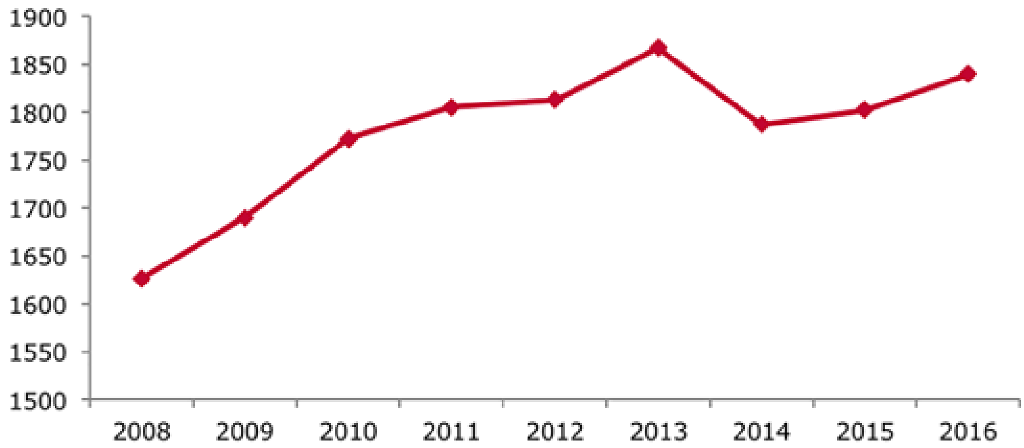
40 Based on annual insurance returns submitted to the Prudential Regulation Authority and FCA. This understates the true number of policyholders as it doesn't include non-insurance company personal pension providers e.g. standalone SIPP Operators, asset managers or Banks with a personal pension scheme.

41 Calculation based on the median value of holdings of £25k per unit/investment trust holding household; original data based on estimates www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/compendium/wealthingreatbritainwave4/2012to2014/chapter5financialwealthwealthingreatbritain2012to2014

42 FCA internal data

43 Those firms which still had 'authorised' status in May 2016, which had been authorised between 2011 and 2015. This does not include registered firms. For example, between 2014-15 131 additional legal entities were registered, all of which were small UK-registered AIFMs.

Figure 3.3: Number of authorised asset management firms[44]



Source – FCA Data based on firm reporting (AUM greater than zero) up to September 2016

3.14 The fund market continues to grow, both in terms of total assets under management (AUM) and net flows into funds.[45] In 2014, there were 104 newly launched funds which were classified to IA sectors[46] receiving £60 billion in net sales over the year. In 2015, there were 172 new fund launches.[47] Equities have been the predominant choice of asset class for flows into newly launched funds in recent years.[48]

3.15 The asset management industry does not appear particularly concentrated,[49] with the top ten asset managers accounting for around 55% of the assets under management.[50] However, a large number of competitors does not necessarily mean there is effective competition. Effective competition implies that firms have sufficient incentives to identify and satisfy clients' demands as efficiently as possible and constantly seek to win the business of clients who use rivals' services. The benefits of achieving effective competition include lower prices for investors, better quality service and greater innovation.

3.16 For example, as shown in Figure 3.4, there is considerable clustering of prices for active equity funds at both 1% and 0.75% for clean share classes (those that do not include distribution payments).

44 Reporting an AUM of more than zero.

45 Asset Management in the UK 2015-2016, A summary of the IA Annual Survey (September 2016) www.theinvestmentassociation.org//assets/files/research/2016/20160929-amsfullreport.pdf

46 Different categories of funds which have been developed by the IA.

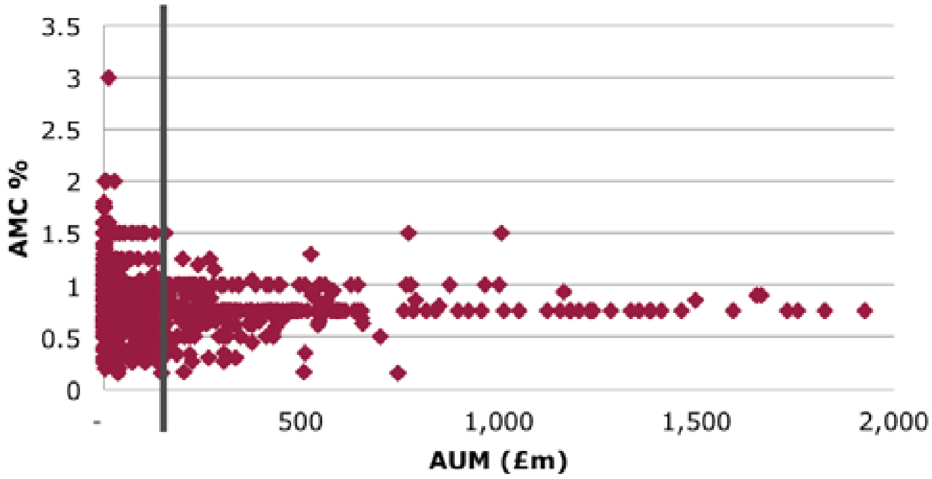
47 Based on Morningstar data.

48 Asset Management in the UK 2015-2016, A summary of the IA Annual Survey (September 2016) www.theinvestmentassociation.org//assets/files/research/2016/20160929-amsfullreport.pdf

49 We estimate a Herfindahl-Hirschmann Index of 780 which indicates that the asset management industry is not particularly concentrated. The Herfindahl-Hirschman Index (HHI) calculates the sum of the squares of the market shares of all firms in the market, in order to obtain an overall figure that indicates the level of concentration in a market, accounting for the relative size of the firms. This estimate should be treated with caution due to our method for estimation. We have based our estimate on assets reported by regulated firms in regulatory returns. Amendments were made to reflect market shares at a group level and estimated cross-holdings. This result is not inconsistent with other third party calculations.

50 Asset Management in the UK 2015-2016, A summary of the IA Annual Survey (September 2016) www.theinvestmentassociation.org//assets/files/research/2016/20160929-amsfullreport.pdf

Figure 3.4 AMC by size of fund



3.17 The top ten fund operators[51] represent approximately 47% of the total UK authorised funds under management at the end of 2015.[52] This proportion has remained broadly unchanged since the 1990s, though the firms in the top 10 have changed over time.[53]

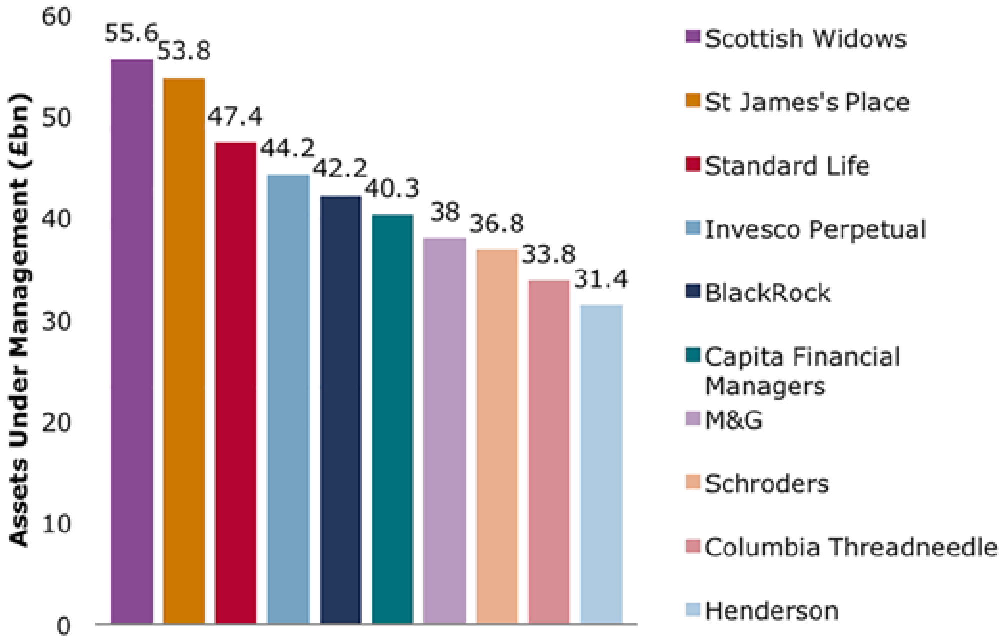
3.18 There has been a slight increase in concentration in equity products over recent years, and multi-asset and fixed income markets appear to be fairly stable.

51 This could be the Authorised Fund Manager, Authorised Corporate Director or the person appointed or responsible for managing of the property held for, or within, a scheme. For the full regulatory definition see the FCA Handbook.

52 The IA define 'UK authorised funds' in this context as UK-domiciled authorised investment funds (which include authorised Unit Trusts and OEICs).

53 Asset Management in the UK 2015-2016, A summary of the IA Annual Survey (September 2016) www.theinvestmentassociation.org//assets/files/research/2016/20160929-amsfullreport.pdf

Figure 3.5: Top ten UK fund operators by total funds under management as at end of 2015



Source – IA data

3.19 Certain parts of the sector do have areas of higher concentration. In Liability Driven Investment (LDI) mandates[54], the top three managers represent 90% of the UK market, based on notional value.[55] The market for pooled mandates[56] is slightly less concentrated (the big three providers account for 75% of the market) and this is where the majority of new business was concentrated in 2014.[57] We discuss our views on competition for LDI mandates in Chapter 5.

3.20 Asset management firms can range from small companies with fewer than ten employees to huge international companies employing thousands. They can take many different legal forms, from partnerships to limited or unlimited companies. Some firms only offer asset management services, while others are part of groups that offer related services such as investment consulting or platforms and may offer access to other asset managers e.g. through a multi-manager fund. Some may also be part of firms which offer a greater variety of products, such as insurance products or pensions administration services.

3.21 Firms may specialise in certain asset classes (such as equities or property), investment strategies (active asset management or passive products or a blend of these which we refer to as 'partly active') or by the types of investor they cater to (such as retail or institutional clients).

3.22 244 of firms authorised in the UK, have passports under an EU directive, meaning that they can sell their services to non-UK European investors. Of the assets managed on behalf of

54 A liability driven investment is a mandate where the investment strategy is based on the requirement for cash flow to meet both current and future liabilities as they fall due (this requires that the future cash flows can be predicted). It is commonly used to describe a range of investment strategies designed for situations where future liabilities can be predicted.

55 FCA FS15/2 *Wholesale Sector Competition Review 2014-15* www.fca.org.uk/news/wholesale-sector-competition-review

56 Mandates which use pooled funds in order to deliver LDI solutions.

57 KPMG *Navigating the UK LDI Market* (2015) home.kpmg.com/uk/en/home/insights/2016/06/2016-kpmg-ldi-survey.html

overseas clients, £1.2tn of assets are on behalf of European clients.[58] Additionally 139 firms have inbound passports, meaning they can sell their services from other EEA jurisdictions into the UK.

Figure 3.6: The number of UK authorised firms with at least one passport under UCITS/AIFMD[59] as at 27 July 2016

	Outbound	Inbound
AIFMD	212	45
UCITS	32	94
Total	224	139

Source – FCA internal data

Products and investments

3.23 There are two broad categories of investment:

- pooled funds (where client money is aggregated together and invested as one portfolio)[60]
- segregated mandates (where the client has an individual investment portfolio)[61]

3.24 Currently there are slightly more assets managed in segregated mandates in the UK, based on AUM (58.2% compared to 41.8% in pooled investment funds).[62]

3.25 Pooled funds can be set up using a variety of forms. These include as a company (e.g. OEICs[63]), a trust (e.g. Authorised Unit Trusts), a partnership or a charity. In the UK, pooled funds can be managed within a number of regulatory structures. For example, they may be set up as UCITS funds (i.e. funds intended for the retail market which comply with the requirements of the UCITS Directive). Not all pooled funds are FCA-authorised – there are also unauthorised pooled investments such as Investment Trusts.[64] Some pooled funds are subject to the Alternative Investment Fund Manager Directive (AIFMD) which regulates the fund manager rather than the fund itself. Many operators of pooled funds will delegate the fund management to a MiFID investment manager[65], either in their own group or to an outside third party so a large proportion of pooled AUM is also subject to MiFID conduct rules.

3.26 UK authorised funds are one of the main ways that UK retail consumers invest, although other vehicles are also used such as unauthorised investment vehicles[66].

58 ibid
59 Undertakings in Collective Investment Schemes and Alternative Investment Fund Managers Directive
60 Funds are subject to COLL or FUND rules which implement UCITS and AIFMD in the UK as well as covering other areas
61 Subject to MiFID conduct rules
62 *Asset Management in the UK 2015-2016, A summary of the IA Annual Survey* (September 2016) www.theinvestmentassociation.org//assets/files/research/2016/20160929-amsfullreport.pdf
63 Open-Ended Investment Company
64 A limited company which invests shareholders' funds. The shares are traded like those of any other public company.
65 An investment management firm subject to the Markets in Financial Instruments Directive.
66 These could include investment trusts as well as Unregulated Collective Investment Schemes (UCIS). UCIS operators have not applied for or obtained FCA authorised or recognised scheme status. However UCIS may not be promoted to the general public (including through advised sales) unless an exemption applies. See PS13/3.

3.27 For regulated Collective Investment Schemes, which are the primary vehicles for pooled investment in the UK, the depositary[67] has oversight duties over the authorised fund manager 'the fund operator'[68] while the operator has oversight over its delegates such as ancillary service providers.[69] Those with oversight responsibilities can require the investment manager to resolve issues, for example, where an asset manager has breached investment restrictions or limits.

3.28 The UK is the fifth largest fund domicile centre in Europe; with approximately 12% of European investment funds domiciled in the UK.[70] The majority of UK domiciled fund sales are to UK investors though some are sold in overseas markets. Fund domicile dictates the tax treatment of the fund whereas fund domicile in combination with other factors dictate the regulatory treatment (See figure 1 and 2). Some associated activities will also depend on the domicile of the fund; UCITS and AIFMD both require that the depositary is based in the jurisdiction where the fund is domiciled.

3.29 Funds can be managed in a jurisdiction that is different from its domicile. While the UK is not the largest domicile centre in Europe it is the second largest asset management sector in the world and 37% of European AUM is managed in the UK.[71] Estimates suggest that at the end of 2013, £775bn of UK assets were managed for pooled funds domiciled in other jurisdictions, three-quarters of which were managed for funds domiciled in Ireland and Luxembourg.[72] Equities are the most popular asset class in terms of number of funds managed in the UK across all fund domiciles. However, Ireland and Luxembourg have a greater proportion of fixed income funds compared to those domiciled in the UK. Our internal analysis (based on IA data) suggests over 9% of UK retail investors' money is now invested in funds domiciled overseas.[73]

3.30 Asset management mandates and pooled funds can be restricted to specific asset classes or subsets, like UK smaller companies. They can also be wider, such as multi-asset, allowing the manager more discretion to switch between assets. Figure 3.7 shows that, although equity remains the largest investment asset class at 39% of investment by UK asset managers, over the last 20 years, the proportion of investors' funds in equities has significantly reduced.[74] The trend for reducing equity holdings is driven by a number of reasons, including market factors, changing demographics, and changes in accounting and regulatory rules.[75]

67 Depositaries are required for UCITS and most AIFMD funds. Where the scheme is an authorised unit trust the depositary will be the fund trustee.

68 A fund operator will typically oversee the setting up of a fund – securing the depositary, custodian and investment managers, preparing documentation and applying for FCA approval. From then on it will manage the scheme either directly or via delegation, providing accounting services, documentation etc.

69 Trustees are required for trust based schemes, unit trusts (often also UCITS), many pension funds and charity funds.

70 The largest fund centre in Europe is Luxembourg where over 27% of funds are domiciled, followed by Ireland (15%), France (14%) and Germany (14%). UK Fund Management 2014, An attractive proposition for international funds (2014), TheCityUK, www.thecityuk.com/research/our-work/reports-list/uk-fund-management-2014/

71 EFAMA Asset Management in Europe www.efama.org/Publications/Statistics/Asset%20Management%20Report/150427_Asset%20Management%20Report%202015.pdf (April 2015).

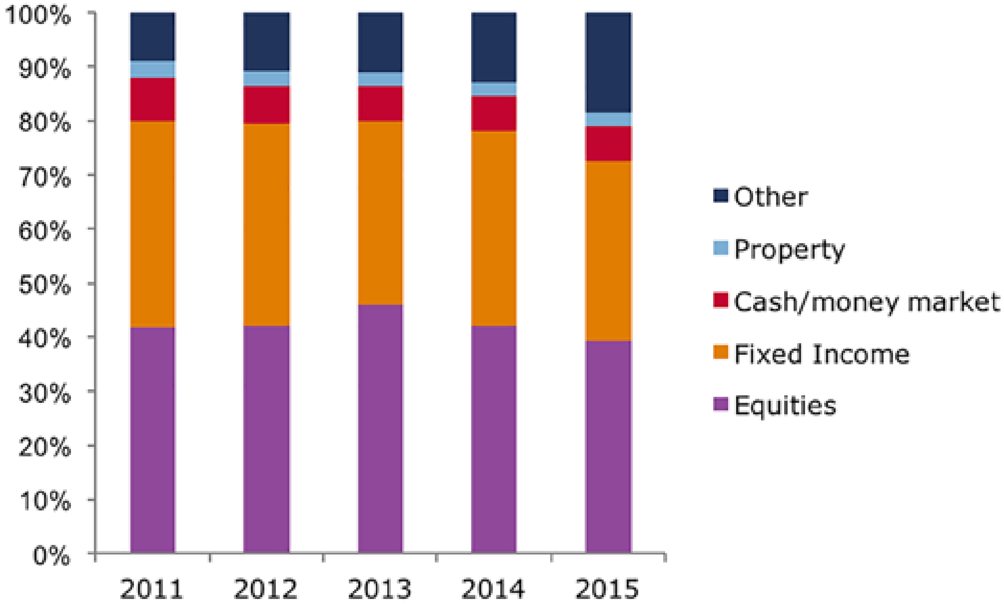
72 UK Fund Management 2014, An attractive proposition for international funds (2014), TheCityUK, www.thecityuk.com/research/our-work/reports-list/uk-fund-management-2014/

73 As of September 2015. This includes non-UK European domiciled funds as well as funds domiciled in the rest of the world, for example in the US.

74 Asset Management in the UK 2015-2016, A summary of the IA Annual Survey (September 2016) www.theinvestmentassociation.org//assets/files/research/2016/20160929-amsfullreport.pdf

75 "The age of asset management?" Speech given by Andrew G Haldane, Executive Director, Financial Stability and member of the Financial Policy Committee (4 April 2014): www.bankofengland.co.uk/publications/Documents/speeches/2014/speech723.pdf

Figure 3.7: Summary of assets under management in the UK



Source: IA data

3.31 Asset management products will typically be marketed as either 'actively managed strategies' or 'passively managed strategies' although in practice some funds may be a blend of these. The majority of the UK market is actively managed (74% compared to 23% passive).[76] The ratio is lower for institutional clients than for the market overall (68% active).[77]

3.32 According to Lipper there were over 36,000 European funds at the end of 2015.[78] In 2013 over 7,000 European funds were available to buy in the UK (of which 3,500 were equity funds). There appears to be plenty of choice among funds that invest in mainstream asset classes. For example, in 2015 there were at least 350 funds classed as 'UK Equity Large Cap' and 47 of those were passive funds.[79] This suggests that, for some asset classes, there are likely to be a significant number of comparable funds available to purchase in the UK.

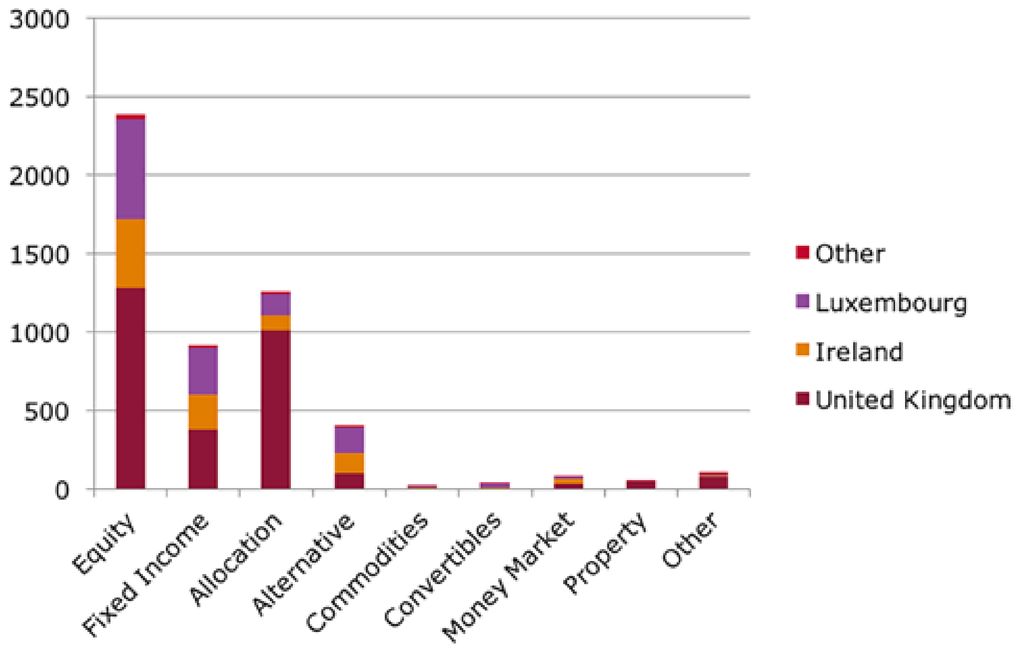
76 ibid

77 ibid

78 share.thomsonreuters.com/PR/Lipper/Reports/EuroFundReview15.pdf

79 Morningstar Direct data as of 18 January 2015.

Figure 3.8: Breakdown of funds available to buy in UK, by asset type and domicile 2015



Source – Morningstar Direct data as of December 2015

3.33 Another type of investment offering is the 'fund of funds' or multi-manager fund. In these funds, the asset manager will select underlying funds or managers (either in-house or third party) and allocate money to be managed by them.

3.34 We analysed the 240 best-selling funds from our sample of platforms for the two years 2014 and 2015. Figure 3.9 shows that around 50% of the best-selling funds in our sample of platforms for 2014 and 2015 were specialist funds, non-UK regional funds or non-mainstream asset classes.[80]

80 FCA analysis, based on combining underlying Morningstar categories

Figure 3.9: The type of best-selling funds on UK platforms

Source – Morningstar

3.35 There have been some market developments in new fund strategies, such as targeted absolute return funds, which seek to deliver an absolute return instead of trying to beat a market benchmark. These accounted for nearly one-fifth of net retail sales for IA classified newly launched funds in 2013. Money allocated to targeted absolute return funds was up to 5.8% of total funds under management by the end of 2015.[81] We discuss market developments and trends in Chapter 9.

Ancillary and third party services

3.36 Often ancillary and third party service providers are appointed by the fund operator, pension fund trustees or the asset manager, but are ultimately providing a service to the end investor. These services can include custody banking (safekeeping of assets), securities lending, unit pricing/issue and redemption, and dividend/coupon collection. Ancillary service providers often bundle a number of these different services together.

3.37 Some services are more directly linked to the investment process, such as research and brokerage services.

Investment consultants and other institutional advisers

3.38 Investment consultants provide services to a range of institutional investors, including pension funds, charities, insurance companies and large corporate employers. DB pension schemes are the largest client base for investment consultants.

81 Asset Management in the UK 2015-2016, A summary of the IA Annual Survey (September 2016) www.theinvestmentassociation.org//assets/files/research/2016/20160929-amsfullreport.

3.39 Institutional investors, including pension funds, employ investment consultants to help them make decisions. In the UK most pension fund trustees must 'obtain and consider the written advice' of a suitably qualified person before making investment decisions.[82] Following consolidation, three big groups share a high proportion of the UK pension consulting market[83] but boutique players with more focused offerings are emerging. Consultants generally advise on what assets to invest in manager selection, and choice of custodian or transition manager[84], but clients can also seek advice on specialist areas.

3.40 Some investment consultants also act as employee benefit consultants (EBC). EBCs provide, among other things, advisory and administration services for organisations' pension schemes, and are a distribution channel for DC pension products.

3.41 A small but fast growing new offering is a service called 'fiduciary management'. The exact terms will be mandate specific but typically the fiduciary manager may accept responsibility for the selecting asset managers and may have discretion to move away from the original asset allocation agreed with the client.

3.42 We set out our findings on how investment consultants affect competition for institutional asset management in Chapter 8.

Platforms

3.43 Most UK retail consumers buy investment products through intermediaries such as financial advisers or tied agents, and more recently, via online platforms and fund supermarkets.

3.44 Platforms are online services, used by intermediaries and consumers, to allow investors to buy a range of funds from different asset managers and hold them together in one account. As well as providing facilities for investments to be bought and sold, platforms are often used to aggregate funds and also arrange custody for customers' assets.

3.45 The term 'platform' is often used to describe both wrap platforms and fund supermarkets, which are similar. One important difference is that investors can often invest in a wider variety of products on wrap platforms (such as direct equities), whereas usually fund supermarkets only offer funds.

3.46 Platforms have become an important part of the investment market, with over three million customers using them to hold assets or invest.[85] According to Platforum there are now nearly £145bn of assets held on 'direct to consumer' (D2C) platforms[86] (see Figure 3.9) and over £340bn

82 Regulation 2 (2a) The Occupational Pension Schemes (Investment) Regulations 2005, 'Before preparing or revising a statement of investment principles, the trustees of a trust scheme must– (a) obtain and consider the written advice of a person who is reasonably believed by the trustees to be qualified by his ability in and practical experience of financial matters and to have the appropriate knowledge and experience of the management of the investments of such schemes '

83 Of the 12 largest investment consultants, the three largest firms account for 71% of investment consulting revenues.

84 Transition Management is used by asset owners, such as pension funds, to help move investment portfolios between different managers or markets while managing market risk and reducing transaction costs.

85 *FCA Review of implementation of platform rules* (3 March 2014) www.fca.org.uk/news/review-of-implementation-of-platform-rules and *UK D2C Guide – Direct Platforms and Investors "Steady as she goes", The Platforum Issue no 5*, (February 2015) Centaur Financial.

86 *The Platform UK D2C Guide Market Overview and Consumer Research* Update, July 2015

assets under administration (AUA)[87] on adviser platforms.[88] Around 80% of new retail investment business is now done through platforms (either directly by clients or by advisers on their behalf).[89]

3.47 Broadly speaking, there are two main platform types:

- those targeted at businesses, primarily financial advisers, but also pension schemes and fund management firms (B2B)
- those targeted at retail investors, called D2C, which offer execution services for investors who choose their own investments, usually without seeking advice.

3.48 The D2C market continues to grow in terms of assets under advice. In 2015 platforms' share of total gross retail sales fell for the time, to 52% down from 55% in 2014[90], as the share of sales through other intermediaries and direct both increased over this period.

3.49 The RDR[91] made significant changes to improve the effectiveness of the fund distribution market. New platforms have launched and market concentration has fallen. The top five adviser platforms accounted for 62% of the adviser platform market and the top three firms accounted for nearly half as at 31st March 2016.[92] As at 30th September 2015 the top three D2C platforms accounted for 54% of the D2C assets under administration. The largest firm accounted for 36% of the market, far ahead of the 10% share of the second largest player.[93]

87 Assets Under Administration (AUA) is the value of assets that a third-party administrator provide services for. Those services can include accounting, custody and tax related duties.

88 Platforum *UK Advisor Guide: Platforms, funds and products* (May 2015)

89 *FCA Review of implementation of platform rules* (3 March 2014) www.fca.org.uk/news/review-of-implementation-of-platform-rules and *UK D2C Guide – Direct Platforms and Investors "Steady as she goes", The Platforum Issue no 5,* February 2015, Centaur Financial.

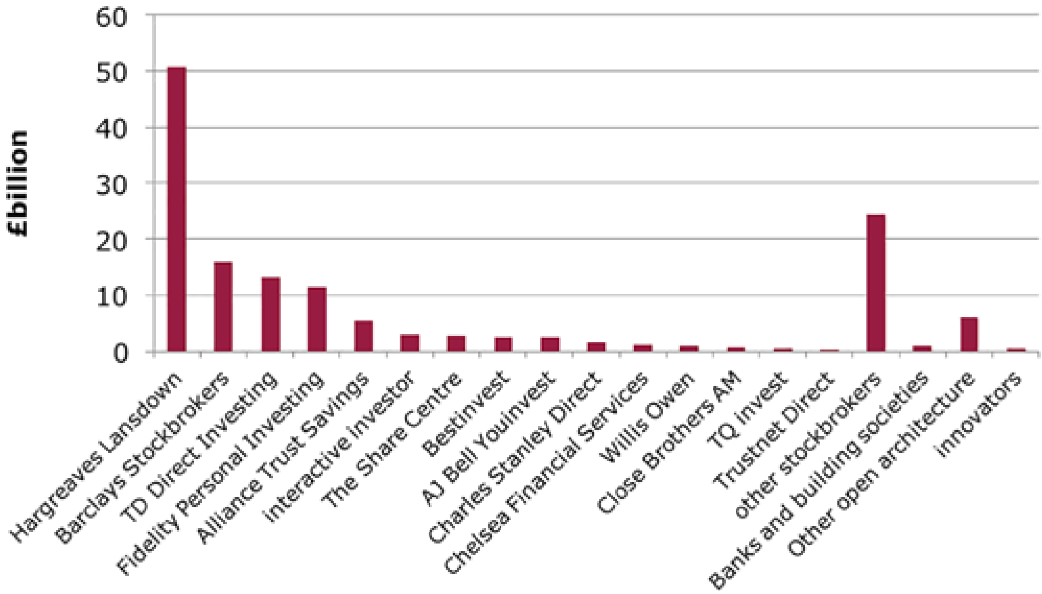
90 Asset Management in the UK 2015-2016, A summary of the IA Annual Survey (September 2016) www.theinvestmentassociation.org//assets/files/research/2016/20160929-amsfullreport.

91 FSA Retail Distribution Review www.fsa.gov.uk/Pages/About/What/rdr/index.shtml

92 Platforum *UK Adviser Platform Guide* (Issue 26)

93 Platforum *UK D2C Guide: Market Size and Structure* (March 2016)

Figure 3.10: Direct Platform Propositions AUM[94]*



*the graph includes other D2C propositions outside of the FCA Platform service definition.

3.50 Many platforms are vertically integrated (where two or more related services are under common ownership) for example, with an asset manager or an advisory firm. We discuss vertical integration between platforms and asset managers in more detail in Chapter 5.

94 The Platforum UK D2C Guide Market Overview and Consumer Research Update (July 2015)

4. How do investors choose between asset managers?

We looked at how investors choose between asset managers. We find that:

- Investors typically consider value for money to be risk-adjusted net returns.
- Investors are not always readily presented with a choice of passive funds through platforms and rating providers.
- When choosing products and providers, we find past performance, reputation and charges matter, with institutional investors more sensitive to price than retail.
- Past performance information is difficult to interpret and compare and does not appear to help when trying to identify future outperformance.
- Tools available to assist both retail and institutional investors in identifying outperforming products, such as best buy lists and investment consultant recommendations, do not allow investors on average to identify products that, after charges, outperformed the benchmark.
- It is important both retail and institutional investors take information about charges into account when choosing and monitoring investment products as charges are a drag on performance and reduce the net returns investors receive. Charges can be difficult for investors to understand, particularly when they are expressed in percentage terms.
- Disclosure of charges is regulated and standardised for retail investors, but less so for institutional investors. Institutional investors would like better information on costs and charges, though the ability to negotiate discounts means publically available information has limited value.
- Switching is fairly infrequent. There are no major barriers to switching but investors find it hard to judge whether and when it is best to switch.
- In terms of how effectively oversight committees negotiate, both size of scheme and expertise matter. There is scope for consolidation to improve effectiveness of oversight, particularly among smaller trust schemes.

Introduction

4.1 For competition to work effectively in asset management, institutional and retail investors need to be able to access, assess and act on information which allows them to identify the products and asset manager that best meet their investment objectives. Once they have made their investment decisions, investors need to be able to judge if their products have delivered value for money and switch to alternative products if not.

4.2 This chapter explores whether these conditions are in place in the asset management sector. In doing so, we address the following questions:

- What do retail and institutional investors perceive as value for money for asset management products?
- How are passive funds presented to investors?
- What factors do investors focus on when choosing and evaluating asset management products/providers?
- Are investors able to assess when to switch product and provider?
- What impact do oversight committees have on investors' ability to get value for money?

4.3 A fuller discussion of these findings can be found in annexes 3-6.

What do retail and institutional investors perceive as value for money for asset management products?

4.4 We asked retail and institutional investors what they viewed as value for money from their asset manager. We also asked asset managers how they delivered value for money to their clients.

When asked most investors broadly think of value for money as risk-adjusted net returns

4.5 Overall, there was broad agreement that value for money for asset management products is a combination of the:

- return achieved
- price paid
- risk taken
- quality of any additional services provided by the asset manager

4.6 This means that most investors broadly think of value for money as risk-adjusted net returns. Asset managers also suggested they add value by their robust investment processes and their ability to manage their own costs effectively, both of which help achieve risk adjusted net returns.

4.7 Within this broad definition, there were different risk tolerances and investment objectives among both institutional and retail investors. A range of institutional investor groups face varying constraints and have different investment objectives.[95] For example, DB schemes generally seek to close any funding gap and ensure they can meet their liabilities. This will inform their investment strategy, risk appetite and preference for certain asset classes. They

95 See Annex 5

may, for example, want to avoid investing in less liquid assets, such as infrastructure. In contrast, charities are less constrained by the need to meet specific future liabilities and can often be more flexible and so have a wider range of available options.

4.8 Among retail investors we identified a range of different reasons for investing, including wanting income in retirement, better returns compared to cash savings and investing as an interest or hobby. These different investment objectives are also likely to inform their risk appetite. Many retail investors will use financial advisers to help them understand their risk appetite against their investment objectives (approximately 78% of retail investment fund sales in 2015 were advised[96]).

4.9 A wide range of investment products compete to meet investors' varied preferences for risk-adjusted net returns. These products' investment strategies can be to actively manage, to 'passively' track an index or to offer a partly active investment strategy. These investment strategies can be used by both retail and institutional investors, although some products are restricted to one or the other.

4.10 Passive funds offer investors the potential to achieve the returns and risk exposure similar to that of the overall target market. Investors may want to use actively managed funds if they want to take on a different level of risk to that of the market with the chance to outperform the market, are confident they can find actively managed funds that will do this or cannot find a passively managed alternative. Some investors will use actively managed funds to aim to try to limit the volatility variations in the value of their investment over time or to seek an absolute return. Asset managers can do this by investing in a range of asset classes, using derivatives or by having discretion to hold some money in cash.

4.11 In some cases, investors highlighted the quality of additional services as a factor in deciding if they are receiving value for money from their asset manager. For example, some retail and institutional investors felt value for money could also be delivered by relevant and timely communications, access to other services and being able to access their investments online. For institutional investors, the quality of the asset managers' communications, and the transparency of, and access to, data are important aspects of whether their asset manager is delivering value. Institutional investors using segregated mandates also considered how closely fund managers comply with the terms of their mandate and generating innovative strategies and ideas was important. Institutional investors valued having access to their manager as and when needed and asset managers who were flexible in meeting their needs.

4.12 We used this feedback to consider whether investors are presented with a choice of products that meet their requirements, whether they can choose and review whether their products have delivered value for money and whether pension schemes put pressure on firms to deliver value for money.

How are passive funds presented to investors?

4.13 In this section we consider the way that passive funds are presented to investors through different distribution channels and the implications this has on investor choice.

4.14 We found that retail investors seeking market returns can choose between a wide range of low-cost index funds, which provide them with exposure to a similar risk and return to the

96 IA submission to the FCA

target market index.[97] Platform best buy lists, third party ratings and potentially financial advisers may influence how retail investors allocate their assets. Our findings suggest that the way the passive funds have been presented to investors might have resulted in some investors overlooking passive funds when making their investment decisions.

Retail investors relying on best buy lists to choose funds for investment may not have been aware of the passive funds available to them

4.15 We found that retail investors seeking market returns can choose between a wide range of low-cost index funds which will give them exposure to a similar return to the target market index.[98] However, best buy lists, third party ratings and potentially financial advisers do not give prominence to passive funds, so some retail investors may not be made aware of the option to choose a passive fund.

4.16 The platforms in our sample offered a wide range of passive funds for investment, although only a small proportion of the funds on best buy-lists are passively managed.[99] We looked at the proportion of passive funds on best buy lists[100] and how this varied across the five platform firms in our sample. We found that passive funds were not listed on any best buy list prior to January 2014. We also found variation across the five firms after this date– one firm had no passive funds in their best buy lists at the end of 2015 while another's had 14% of its best buy funds being passive at the end of 2015. However, for the latter platform, all of these were, until recently, part of a separate best buy list.

4.17 Figure 4.1 shows that in December 2015 10.4% of funds on best buy lists were passive funds and that the figure was similar in December 2014. When we remove the passive funds which were listed on a separate best buy list by one of the platforms, these numbers fall to 6.9% in December 2015 and 5.7% in December 2014. This suggests that those retail investors relying on best buy lists to choose funds for investment may not have been aware of the passive funds available to them.

Figure 4.1: The number of passive funds on best buy lists[101]

	Dec-15			Dec-14		
	Active	**Passive**	**% passive**	**Active**	**Passive**	**% passive**
On either the main list or a separate list	242	28	10.4%	216	23	9.6%
On the main list only	242	18	6.9%	216	13	5.7%

Passive funds are likely to be assigned an average rating by some third party rating systems

4.18 We have examined whether third party ratings give prominence to certain investment strategies. Third-party ratings are commonly presented to investors by distributors such as platforms. They are used by advisers to decide which funds to recommend to their clients. Past research on US funds suggests that fund ratings are influential in driving flows of assets into and out

97 The difference between the market returns and the return of the fund is termed the tracking difference, or excess return. The tracking difference for a passive fund is typically small and negative, reflecting the fact that a passive fund typically slightly underperforms against its target market index.

98 The difference between the market returns and the return of the fund is termed the tracking difference, or excess return. The tracking difference for a passive fund is typically small and negative, reflecting the fact that a passive fund typically slightly underperforms against its target market index.

99 Our research has not encompassed the presentation of passive funds in mail-based advertising or a full analysis of website design.

100 Some firms provide multiple best buy lists. We have included funds as part of the best buy list even where they are on a separate best buy list, for example, The Hargreaves Core Tracker list.

101 This sample covers five D2C platforms

of funds. Our analysis also suggests that retail investors use third party ratings when they make investment decisions. In particular, our econometric analysis shows that investors react to changes in the Morningstar Star rating, one of the most used ratings systems. A change in star rating from not-5-stars to 5-stars leads to a significant increase in the total net assets that are invested. We have also found that assets are concentrated in funds with higher Morningstar star ratings.

4.19 The Morningstar Star rating is a quantitative, risk-adjusted comparison of historical fund performance net of costs. The methodology is applied to active and index tracker funds, and makes no distinction between them. We have found that the methodology used to generate this rating means that index-tracker funds are likely to be assigned an average rating and generally only a minority of these receive a high rating. Given our finding that assets are concentrated in higher rated funds, and that a change in star rating from not-5-stars to 5-stars leads to a significant increase in assets, there is a risk that the rating process overlooks tracker products in favour of products with high, and particularly 5-star, ratings. The outcome of this could be an over-allocation of assets into active share classes at the expense of index tracker products. This would be the case if, on average, the future returns from 5-star rated share classes were lower than the future returns of index trackers.

4.20 We have performed an analysis to compare the performance of 5-star rated share classes with non-5-star rated share classes. We found that 5-star share classes do not significantly outperform benchmarks net of charges; net-of-fees excess returns above benchmarks[102]; this means that after charges the returns above the benchmarks are statistically indistinguishable from zero. However, the difference in net excess returns between 5-star rated share classes and not-5-star rated share classes is positive and significant. Therefore although, on average, 5-star rated funds did not outperform their benchmarks, 5-star rated funds performed better than not-5-star rated funds. 5-star share classes earned greater net excess returns than other share classes. This finding is consistent for different holding periods of 3 and 5 years. However, this analysis does not directly address the question if investors choosing only 5-star rated products would on average have achieved higher returns had they chosen tracker funds. We will investigate the relative performance of 5-star funds and passive funds after we have published this interim report.

4.21 We have not looked at how financial advisers shape choices within this study. However, according to results from the Platforum consumer research[103] partially-advised investors are much less likely to invest in passive funds compared to non-advised investors. So it is possible that the proportions for advised clients would be lower still, which may reflect advisers not considering passive fund options for their clients.

4.22 The evidence presented in this section suggests that in the past investor might have overlooked the potential benefits of placing their assets into passive funds.

What factors do investors focus on when choosing and evaluating asset management products and/or providers?

4.23 This section explores the factors different investor groups focus on when choosing and evaluating asset management products and/ or providers, and the implications this has for market outcomes.

102 These are defined as returns after charge, in excess of the Morningstar Category benchmark

103 Platforum consumer insights update, July 2016

Past performance remains an important driver of choice, particularly for non-advised retail investors

4.24 In this section we set out our findings from our analysis of the factors investors say they focus on to inform their choice of fund, and the factors that drive fund flows.

4.25 As part of the market study, we commissioned research into how non-advised retail investors choose their investment products. When asked which factors were influential in the respondent's choice of funds, 44% of respondents stated past performance was an influential factor and reputation was mentioned frequently.

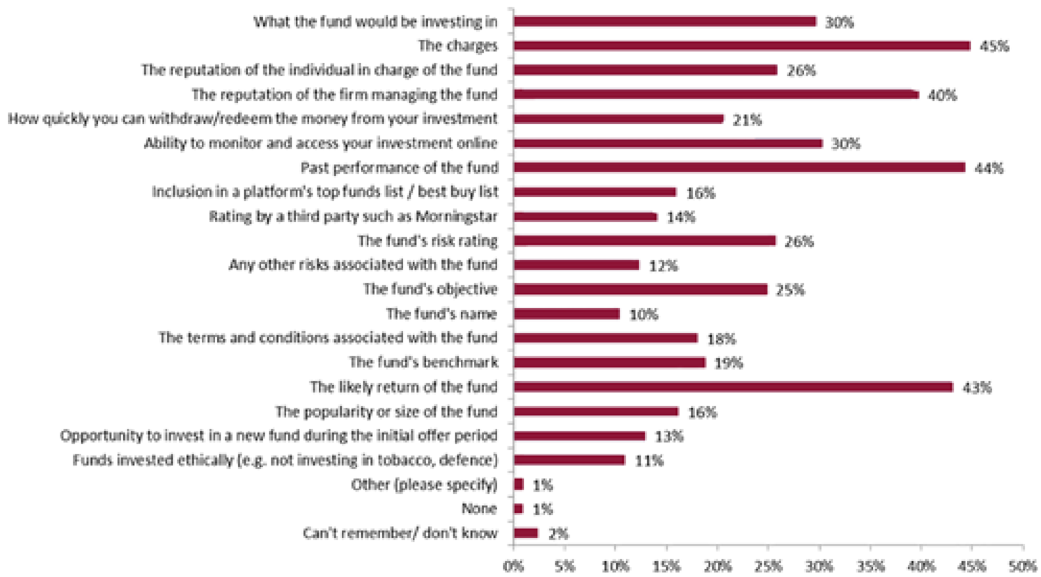
4.26 There are a range of tools available to retail investors, including best buy lists and third party fund ratings, which can guide their choice. The potential advantage of these tools is that they may reduce investors' search costs and may help them overcome some of the challenges faced by investors who do not have the skill or time to identify outperforming funds and asset managers. A relatively small proportion of respondents stated they took into account ratings by third parties such as Morningstar (14%) and inclusion in a platform's top rated fund list/best buy list (16%) when choosing between asset managers.

4.27 The level of, and changes to, D2C platforms' recommendations in our sample have a statistically significant effect on the amount of investments made into funds available for sale in the UK. For example, when analysing annual net flows we found that an additional recommendation from one of the D2C platforms in our sample in the previous year leads to an increase in the current year of £51m in assets, or to an increase of 29%. Better relative past performance is linked to higher net flows into funds, and share classes with a five-star Morningstar rating were also associated with higher net flows. We have also found that other things equal, more expensive share classes experience relative falls in total net assets. This evidence suggests that investors pay some attention to charges. However, this may be restricted to share classes with above average prices. We intend to perform further analysis on the drivers of fund flows, and the added value of best buy lists and ratings, following the interim report.

4.28 The evidence on whether investors take charges into account is mixed. Most (77%) non-advised retail investors who responded to our survey said they looked at charges when they made their initial investment decision and 45% said charges were an influential factor in their choice. Whilst this suggests charges featured in decision making, over half of respondents did not recall charges being influential in their decision, and other evidence also suggests awareness of charges is quite low. In the qualitative research we commissioned, respondents typically did not mention charges unless they were prompted. Our quantitative survey found that less than half of respondents reported paying any fund charges.[104]

104 For a full discussion of our survey results please see Annex 3.

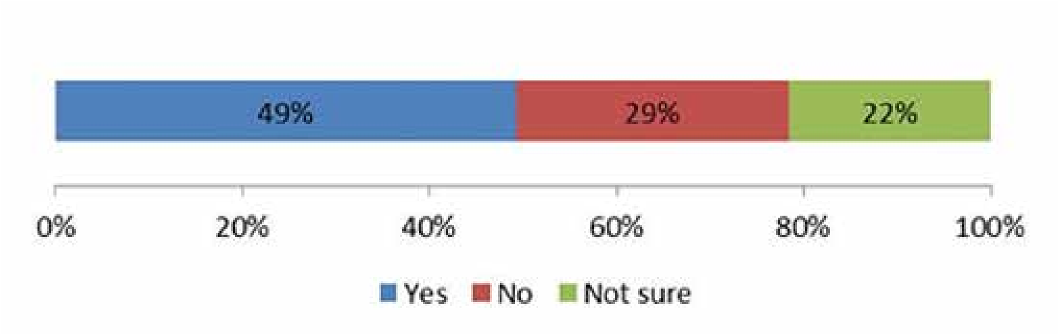
Figure 4.2 – Which of the following factors, if any, were influential to any extent in your choice of the funds in your investment? [105]



Source: NMG Consumer Research (2016)

4.29 As shown in Figure 4.3, more than half of retail investors in our survey did not know for sure that they were paying fund charges on their investment product.

Figure 4.3 – Do you pay fund charges on your most recent investment product?



Source: NMG Consumer Research (2016)

4.30 These findings suggest that past performance and reputation are important drivers of retail investor choices. Third party comparison tools have a role. The evidence on charges is mixed, suggesting that some investors are more price aware than others.

4.31 Among institutional investors we found that past performance, manager reputation and charges appear to inform decision making. In our online survey to institutional investors we asked respondents to rate, in terms of importance, the factors they considered when choosing a manager. On average, the level of management fees was rated as most important, followed by the fund manager's reputation.[106]

105 Sample base: respondents who have looked at the funds purchased (2049).

106 Scale was from 1-5. 1 - Very important and 5 – not at all important.

4.32 Past performance remains an important feature, with smaller investors feeling more strongly than larger investors that this is an important consideration when choosing a fund manager. The smallest investors rated past performance, on average, higher than management fees. 53% of respondents with assets under £50m ranked past performance as more important than management fees compared to only 13% of respondents with assets over £50m.[107]

Figure 4.4 – Factors that are important to institutional investors when selecting asset managers

Respondents were asked to score each of the following factors in terms of importance on a 1-5 scale (1 - very important; 5 not important)	Average score (ranked)
Management fee	1.82
Reputation of fund manager	1.9
Past performance of manager	2
Specialisation in your area of interest	2.17
Terms and conditions	2.29
Range of funds available	2.57
Other fees	2.64
Investment consultant recommendation	2.72
Rating of funds	2.73
Size of funds	2.79
Fund / investment documentations	2.87
Performance fee	3.05
Brand	3.08
Marketing pitch	3.67
Marketing materials	3.9

Source: Institutional online survey, figure 14 in annex 5.
Sample base: 50 respondents; unweighted

4.33 Investors who had received investment consultant advice said, consultant recommendations were in the top five factors they considered as important,[108] with those with assets over £50m giving it greater importance.[109] Here, investment consultant recommendations were among the top three factors investors considered as important. Our discussions with institutional investors also suggested that investment consultant recommendations and ratings were influential in selecting managers and informed the choice of fund managers that are considered.

107 Statistically significant at 95% confidence using Chi^2 and Fischer exact test.
108 Based on 31 respondents who had used investment consultant advice.
109 24 respondents who had used investment consultant advice and had more than £50m in assets.

Figure 4.5 – Factors that are important to institutional investors that use an investment consultant when selecting asset managers

Respondents were asked to score each of the following factors in terms of importance on a 1-5 scale (1 - very important; 5 not important)	Average score (ranked)
Management fee	1.91
Reputation of fund manager	2.19
Specialisation in your area of interest	2.19
Past performance of manager	2.23
Investment consultant recommendation	2.25
Terms and conditions	2.37
Other fees	2.39
Range of funds available	2.66
Rating of funds	2.68
Size of funds	2.71
Fund / investment documentations	2.74
Performance fee	3.00
Brand	3.47
Marketing pitch	3.53
Marketing materials	3.87

Very important

Not important

Source: Institutional online survey
Sample base: 31 respondents; unweighted

4.34 Our econometric analysis found that investment consultant recommendations drive net flows, after controlling for other variables.[110] The results show that flows respond quickly to investment consultant recommendations, increasing in the quarter following the high rating, and this impact appears to persist over a long period of time.

4.35 Institutional investors told us they are increasingly taking charges into account when they make their investment decisions and review the performance of their investments. They gave us a range of examples of how they are more closely monitoring costs (see annex 5). As Figure 4.4 shows, the level of management fees is the most highly rated factor informing fund manager selection across all institutional investors.

Past performance does not help investors identify funds that are likely to outperform in the future, mainly because the majority of firms do not persistently outperform

4.36 Given that retail investors and, to some extent, institutional investors appear to focus on past performance when choosing between funds and asset managers, we explored how useful this is in identifying asset managers that deliver the greatest risk-adjusted net returns.

4.37 There are two key reasons why relying on past performance information may not help investors assess in advance whether a fund or asset manager is likely to deliver the best risk-adjusted returns:

- it may be difficult to interpret and compare past performance information

110 Controlling for past performance, performance rankings versus other funds in the same category, excess performance, total net assets, and fees. This is explained in further detail in Annex 6.

- even if past performance is easy to interpret and compare, good performing funds may not persist over time (we explore performance persistence in Chapter 6).

4.38 Investors often want to compare the past performance of different funds. However, there are a number of reasons why it can be difficult to find comparable past performance information. First, performance can be measured over different timeframes. Under current rules, UCITS funds must display their past performance in a bar chart displaying up to 10 years performance in percentage terms in the KIID. Where a UCITS fund has a track record of less than five calendar years a template with slots for the last five years must be included with blank slots shown for any year for which data is not available.

4.39 However, funds set up at different times will have performance measures over different time periods, which can make comparison difficult. This difficulty is most pronounced when some funds' performance history spans volatile market events, while others' do not. Similarly, the performance of one fund might be measured more frequently than another,[111] which can affect the perceived volatility of the fund's performance, especially over periods of volatility in the relevant market.

4.40 Second, funds that perform poorly are often liquidated or merged into another fund. Figure 4.6 shows that across all types of equity funds available to UK investors in 2006, only around half have survived in 2016, meaning they were not merged or liquidated). This means that the past performances of all existing funds on the market at any given time do not reflect the performance of funds that have been liquidated or merged. This may give investors the false impression that there are few poorly performing funds on the market. This is known as the 'survivorship bias'.

Figure 4.6 – The percent of European Equity funds that survived 2006-2016[112]

Fund category	Number of funds at start of 10 year period	Survivorship (%) – the percent of funds that survived at the end of the 10 year period
Europe Equity	73	39.73
Europe Ex-U.K. Equity	139	57.55
U.K. Equity	524	45.99
U.K. Large-/Mid-Cap Equity	331	42.30
U.K. Small-Cap Equity	74	55.41
Global Equity	323	53.87
Emerging Markets Equity	58	67.24
U.S. Equity	171	45.03
Total	**1693**	**48.49**

4.41 Not all retail investors compare performance against a benchmark. Through our interviews with non-advised retail investors, we found that very few respondents actually make assessments of fund performance against an industry benchmark. This may reflect the fact that few funds display their performance against a benchmark in marketing material and in their KIID.[113]

111 While the KIID requires fund managers to display performance yearly, other sources of information can measure performance more frequently

112 SPIVA Europe Scorecard (Mid-Year 2016) us.spindices.com/search/?ContentType=SPIVA

113 The Key Investor Information Document is a two-page document delivered to investors in UCITS funds which sets out information on fund objectives, risk profile, charges, past performance and other practical information.

4.42 Where investors and their advisers do use a benchmark, or a manager chooses a benchmark to illustrate their performance, it can be challenging to find one benchmark which captures the manager's ability to add value through asset selection.[114] For most funds, the fund manager will set out an investment strategy, for example the fund's intended asset allocation, whether it will invest in large or small firms (by market capitalisation) and the regions in which investment will take place. Within these constraints, the past performance of most funds will depend on the manager's ability to identify and invest in assets whose value will increase over time.[115] To accurately assess comparative performance, a fund should ideally be compared to a benchmark which reflects the same constraints so that the past performance of a fund, relative to this benchmark, fully reflects the manager's ability to add value through asset selection.

4.43 Readily-available and recognisable benchmarks (such as major market indices, or peer group performance) are regularly used in fund documentation and third party comparisons. Though such a benchmark may capture some part of a fund's investment strategy, it may not accurately reflect its overall investment strategy and associated risks. For example, the IA sector categorisation[116] allows funds to invest up to 20% of their assets outside the primary asset class specified in the sector category. This means that funds within the same IA sector category may hold a significant share of their assets in different markets, and so be exposed to different market risks. Therefore past performance, when viewed against these imperfect benchmarks, such as peer group or market benchmarks,[117] may not reflect the fund manager's ability to add value through asset selection.

4.44 Additionally, as we outline in Annex 3, we found that in an experimental environment, presenting past performance against a benchmark can confuse investors. They may choose a fund with poorer absolute performance when the fund's past performance is illustrated as outperforming a benchmark.

4.45 Whilst asset managers should be using an appropriate, comparable benchmark for mainstream strategies, we recognise that the more bespoke the strategy the harder it is to benchmark. Investors also need to be relatively sophisticated to use benchmark data.

4.46 In Chapter 6 we explore whether past performance information gives investors a reliable insight into whether funds that have historically under and outperformed their benchmarks are likely to continue to do so in the future.

Comparator tools did not allow investors on average to identify products that, after charges, outperformed the benchmark

4.47 Retail investors can use best buy lists to help them choose funds. We analysed whether platform best buy lists help investors identify funds that will outperform funds which are not on the best buy list and funds that will outperform their benchmark. Our analysis of the performance of share classes on best buy lists of D2C platforms shows that, across all categories taken together, they perform better than non-recommended products. This finding holds across different assumed holding periods. However, the average net excess returns of share classes

114 Mainstream index providers are predominantly focused on established cap-weighted indexes. Though it is possible to construct customised benchmarks reflecting specific factor-weightings or create composite indices, the associated costs can be substantial. Additionally, custom benchmarks may not be accessible, intuitive, or allow for easy comparisons by consumers. As such, fund managers may prefer to use the same "standard" benchmarks as their peers.

115 Some targeted absolute return funds can bet on the price fall of an asset.

116 IA sectors divide the fund universe by the type of assets invested, some with a geographical focus and some with a focus on investment strategy. Funds select the most appropriate category for them (or may remain unclassified) and this may be used by third parties who are undertaking peer analysis or are showing relative performance for example on platforms or on Morningstar.

117 If such a readily-available benchmark exists. Some funds do not provide a benchmark where there is no appropriate, readily-available benchmark.

on D2C platform best buy lists were not greater than their benchmarks. Share classes on these lists achieved a net performance with little or no significant excess return over benchmarks.

4.48 Investors can also use third party ratings to help them choose funds. We have analysed whether two popular third party ratings, the Morningstar Rating (also known as "the Morningstar star rating") and the Morningstar Analyst rating help investors identify funds that will outperform the benchmark. We have found the following:

- Share classes awarded a 5-star rating by Morningstar[118] do not significantly outperform their benchmarks net of charges; net-of-fees excess returns are statistically indistinguishable from zero. However, the difference in net excess returns between 5-star rated share classes and non-5-star rated share classes is positive and significant, meaning that 5-star share classes earned greater net excess returns than other share classes. This finding holds if we assume different holding periods of 3 and 5 years; and

- Share classes awarded a Gold, Silver or Bronze (GSB) Morningstar Analyst rating[119] do not significantly outperform their benchmarks net of charges; net-of-fees excess returns are statistically indistinguishable from zero over various different holding periods. While we found that the difference in net excess returns between GSB Morningstar Analyst rated share classes and non-GSB rated share classes is positive and significant (meaning that 5-star share classes earned greater net excess returns than other share classes), this finding does not hold when we examine 3 or 5 year holding periods.

It can be difficult for investors to assess whether some funds that aim to deliver an absolute return deliver value for money

4.49 There are a range of different funds available to investors who want to manage the volatility of their investments, including:

- Money market funds: These are funds which invest their assets in money market instruments.

- Protected funds: These are funds, other than money market funds, which aim to provide a return of a set amount of capital back to the investor. This is either explicitly protected or delivered through an investment strategy highly likely to achieve this objective plus the potential for some investment return.

- Targeted absolute return funds (ARF): Funds managed with the aim of delivering positive returns in any market conditions, but returns are not guaranteed. Funds in this sector may also have a net return target or objective that is significantly greater than zero.

4.50 We considered if investors can assess the value for money offered by targeted absolute return funds. We have focused on these funds because of their increasing popularity amongst investors; targeted absolute return funds were the bestselling Investment Association sector in 2015.[120]

118 The Morningstar Rating is a quantitative, risk-adjusted comparison of fund performance net of costs. Costs are defined to include items such as front loads (for example initial sales charges), deferred loads and redemption fees. The quality measure chosen by Morningstar for this rating is therefore past performance after sales costs and expenses, adjusted for risk.

119 The Morningstar Analyst rating is a qualitative, forward-looking measure that reflects an analyst's expectation of a fund's future performance relative to its peers over a business cycle. The expectations for each fund that is analysed are summarised using a five-tier scale with three positive ratings of Gold, Silver, Bronze, a Neutral rating, and a Negative rating. The analyst rating is constructed based on an assessment across five areas. These are past performance, price (fees and trading costs), quality of investment team, parent organisation, and investment process.

120 See Investment Association statistics by sector: www.theinvestmentassociation.org/fund-statistics/statistics-by-sector.html?what=table&show=25

4.51 Targeted absolute return funds typically appeal to customers who wish to reduce the risk of negative returns, and secondarily to achieve some positive return on their investments with less risk than a typical single asset class fund.

4.52 Funds in this sector typically market themselves as aiming to achieve a positive return in all market conditions over a set period (typically 1-3 years). Many of these funds will also have a secondary objective of aiming to deliver a cash proxy plus a certain percentage, e.g. LIBOR + 5%, or the Bank of England Base Rate + 4%. Although these returns are not guaranteed, the fact that these funds tend to hold themselves out as offering low risk, stable returns means that investors may expect stable positive returns from them.

4.53 Some ARFs do not present their performance against the relevant returns target. For example, a fund may have a secondary performance objective of beating cash by 2% (in addition to the primary objective of making an absolute return), but presents its performance against a cash benchmark. This means that the fund performance can still look good when the fund objective has not been achieved.

4.54 A number of ARFs funds also levy performance fees on a lower performance objective than the secondary objective held out to customers.[121] This means that the manager is remunerated for performance that is lower than the secondary objective held out to customers, potentially creating a misalignment between what investors and firms perceive to be outperformance.

4.55 The majority of absolute return funds with a secondary objective show this performance objective without the deduction of fees and charges. This makes it difficult for consumers to assess what the actual return will be once fees and charges have been accounted for.

Whilst there have been some improvements, transaction costs remain difficult to assess

4.56 In this section we explore what cost and charging information is available to investors in funds and institutional investors in segregated mandates and whether contractual clauses make it harder to compare products. It is important that both retail and institutional investors take charging information into account when choosing and monitoring investment products as:

- **Charges will significantly affect the net return investors receive:** charges are a drag on performance and reduce what investors actually receive. These charges decrease returns each year, whereas performance is volatile.

- **It is difficult to understand what impact charges will have on returns by only looking at net past performance:** Past performance is always presented net of charges, without illustrating the impact fees have had on returns.

- **Charges are certain but performance is not:** Focusing on past performance, net of charges, is unlikely to help an investor understand what they can expect from uncertain future returns. However, the asset management fees that an investor will pay are certain and therefore this can help investors to focus on the only certain element of their future net return.

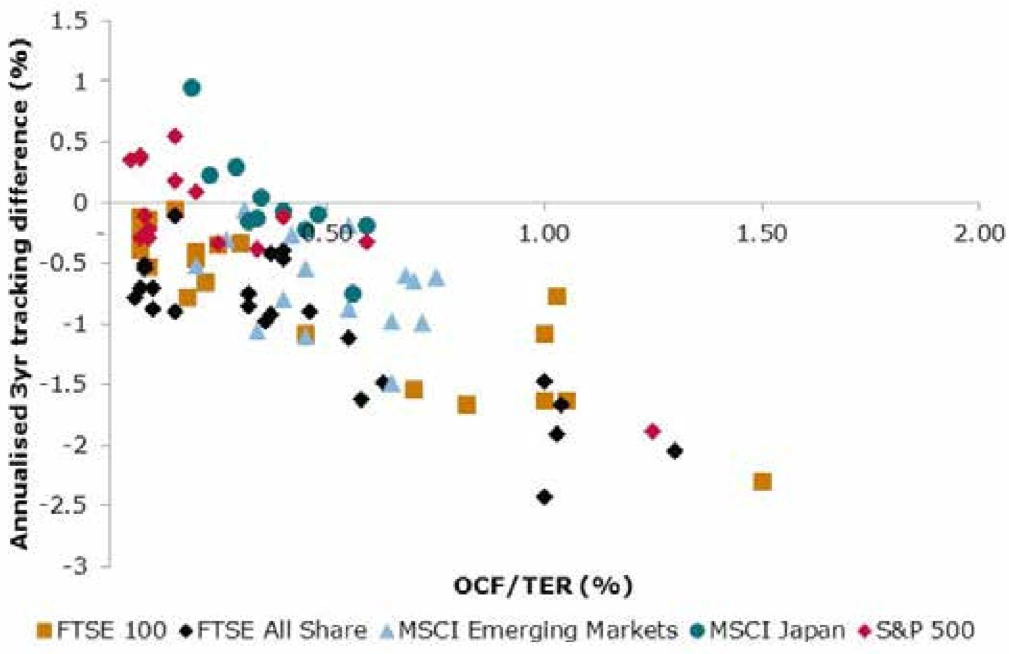
- **Focusing on charges may help to strengthen price pressure:** by understanding the costs of their investments, there may be scope, particularly for larger institutional investors, to negotiate more effectively with fund managers and make savings. We heard

121 An additional objective to making an absolute return.

examples of institutional investors making significant savings by reviewing the costs of their investment strategy.[122]

- **For passive funds, charges are a large component of the tracking difference**. This means that a useful rule of thumb for selecting a fund with minimal tracking difference is to find passive funds with the lowest declared Ongoing Charges Figure or Total Expense Ratio. This is illustrated in Figure 4.7 which shows that, based on a small database on TrustNet, the declared fees (i.e. OCF or TER) is a significant component of the tracking difference and correlates with the historical tracking difference of the fund.[123]

Figure 4.7: OCF vs Annualised 3yr tracking difference, by tracked index



Data Source: TrustNet.com, on 13 September 2016. Analysis by the FCA.

4.57 There are a range of current and proposed disclosure rules for pooled fund structures which aim to improve the transparency of charges. However, we find that retail investors and institutional investors (typically smaller institutional investors) that use pooled funds still face problems getting and comparing charging information.

4.58 While asset managers disclose the cost of many services paid for by the fund, the extent of disclosure can vary depending on the type of fund. Currently, UCITS fund managers must disclose an on-going charges figure (OCF) on each fund's KIID.[124] The OCF includes a variety of costs borne by the fund, including expenses for operating the fund and the remuneration of anyone providing services to it. The remuneration payments included in the OCF includes all payments to the management company of the fund (e.g. the AMC), the directors of the fund

122 For example, one institutional investor we interviewed had reviewed their costs, reduced them through streamlining the services they bought (including reducing the number of fund managers) and were able to make significant cost savings of around 30% without impacting their ability to achieve strong returns.

123 Correlation coefficient of -0.75 based on 86 funds in the sample of funds benchmarked to the FTSE 100, FTSE All Share, MSCI Emerging Markets, MSCI Japan, and S&P 500. These market indices were chosen as they had the highest number of funds (over 10 each) benchmarked to them in the TrustNet dataset.

124 COLL 4.7.8G; CESR Guidelines – Methodology for calculation of the ongoing charges figure in the Key Investor Information Document (10-674).

if it is an investment company, all costs taken from the UCITS fund for delegated functions, including, custody payments and valuation and fund accounting services. Any remuneration of the management company (or another person) from fee sharing agreements are also included in the total ongoing charges figure.[125] Payments made to firms providing outsourced services to the management of the UCITS fund are also included in the OCF.[126] These costs should be calculated based on recent actual charges where possible, or based on reasonable estimates until it is possible to calculate recent actual charges. The OCF disclosed in the KIID should be based on the total of all these payments made over a specific period, with certain exceptions.[127]

4.59 The OCF does not include 'one off' fees, such as entry or exit charges or performance fees. However, these must be disclosed on the KIID, allowing investors, in principle, to take these fees into account before investment decisions are made. So investors can to take into account a proportion of the total fund charges they will incur before making an investment decision.

4.60 However, under the current disclosure rules, the OCF does not include implicit or explicit transaction costs (the costs to buy and sell securities). Other charges, such as dilution levies and adjustments,[128] may also be applied to the fund but are also not calculated and communicated in advance. As a result, investors are not currently able to find information which reasonably estimates the total impact that charges will have on their net returns.

125 Possible examples include the remuneration of a management company through a fee sharing agreement with a broker on transaction costs, or with a custodian on stock lending income

126 Including valuation and fund accountancy services and transfer agents; registration and regulatory fees audit fees; payments to legal and professional advisers and any costs of distribution

127 Exceptions include, for example, performance-related fees payable to the management company and implicit and explicit transaction-related costs.

128 For funds operating a single pricing policy, managers may reserve the right to charge a dilution levy/adjustment to protect existing shareholders from the costs of buying or selling underlying investments, as a result of large investors joining or leaving the fund. The amount of any such dilution levy/adjustment is calculated by reference to the estimated costs of dealing in the underlying investments. When the firm imposes a dilution levy/adjustment on a particular investor or group of investors, this is paid into the fund. Dilution adjustment affects everyone who deals on a particular day when there are large investors joining/leaving the fund, whereas Dilution levy only affects the individuals who trigger the price movement.

Figure 4.8: Costs included in the OCF

Cost	Explanation	Included in the OCF?
Annual management charge	The cost of managing the fund, paid to the asset manager	Yes
Depositary fees	The cost of overseeing the management of the fund's portfolio	Yes
Custodian fee	A charge by the company who has been appointed to safeguard the fund's investments	Yes
Audit fees	The cost of verifying the fund's account by an external accountant	Yes
Regulatory fees	A levy imposed by the FCA to cover the costs of regulation	Yes
Printing fees	Cost to produce written report and accounts of a fund's performance to send out to investors	Yes
OCF of underlying funds	The weighted OCF of any funds in which the fund is invested. Applicable to fund of funds	Yes
Administration and investor dealing fees	Fees paid to the fund's administrator	Yes
Entry and exit charges	The charge of purchasing or selling units in the fund	No
Brokerage charges	The fee charged by the brokerage to facilitate trades	No
Borrowing costs	Interest paid on outstanding debt	No
Performance fees	Payments to the asset manager if certain performance targets are achieved	No

4.61 Non-UCITS retail schemes (NURS) are required to either apply requirements equivalent to the KIID regulations, so calculate and display OCF or provide charges in the simplified prospectus or as a 'key features' illustration. In practice, most NURS funds provide KIID equivalents and therefore the OCF should be largely comparable and include ancillary service costs. There are no specific disclosure requirements for costs and charges for investment trusts and other non-authorised structures. However, all regulated firms need to adhere to the FCA's Principles for Business (PRIN) which includes the requirement that 'a firm must pay due regard to the information needs of its clients and communicate information to them in a way which is clear, fair and not misleading' (Principle 7). This principle also applies to regulated firms who are managing segregated mandates.

4.62 The charging information that investors receive may be hard to understand. The OCF is presented as a percentage to two decimal places[129] and there is evidence that investors find percentages harder to understand, including:

- Academic studies from the US suggest that consumers do not fully understand the compound effect of annual costs on long term investment returns. Chater, Huck & Inderst (2010) found that European investors made worse investment decisions when the best choice was given as percentages. Investors also struggled to identify the best choice when annual returns were not compounded over the lifetime of the investments.[130]

129 See CESR guidelines section 10: www.esma.europa.eu/sites/default/files/library/2015/11/10_674.pdf

130 Chater, Huck and Inderst (2010) *Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective*. The authors note that 'subjects made worse investment decisions when the optimal choice was harder to understand, for example when fees were framed as percentages or when annual returns were not compounded over the duration of the investment.'

- An OECD survey on financial literacy and inclusion[131] found that only 61% of UK respondents were able to respond correctly to a simple question on the calculation of interest plus principal, and only 37% were also able to correctly identify the effect of compound interest.[132]

- Consumer testing by the European Commission found that a respondent's ability to assess costs varies significantly depending on the way the costs are presented. They found respondents had difficulties in comparing both overall costs and different elements of costs between products, identifying how costs apply and estimating early exit costs.[133]

- The research firm we commissioned tested whether investors can differentiate between the fees they pay under different fee structures. As illustrated in Annex 3, 12% of respondents chose the more expensive option when charges were presented in percentages and around one-in-five (21%) respondents either do not have a preference or do not know.

4.63 The incoming European PRIIPs Regulation will introduce a key information document (KID) for most investment products.[134] The current Key Investor Information Document is a standardised regulatory disclosure document that firms must give a retail investor before they buy a product. The PRIIPs KID will include costs and charges shown in monetary as well as percentage terms, and also indirect costs such as transaction costs. However, there is currently no obligation on fund managers to show charges in monetary amounts in other information documents for retail investors.

4.64 As well as the difficulty of getting complete charging information before making a decision, investors can also find it hard to get an estimate of the charges taken from their fund on an ongoing basis.

4.65 Institutional investors also face challenges accessing complete and comparable charging information. If institutional investors invest in a UCITS fund they will be given an OCF (or an equivalent for a non-UCITS fund), which includes the costs illustrated in Figure 4.7.

4.66 However, the disclosure of costs and charges for segregated mandates is less regulated. The institutional investors we spoke with, including those that invested in segregated mandates, highlighted costs that are more difficult to find and said certain investment products are less transparent overall. These were:

- **Transaction costs:** We heard that getting transaction cost[135] information has been difficult as managers do not make it readily available, although the transparency of transaction costs should improve following recent regulatory changes. From April 2015, IGCs and trustees overseeing defined contribution pension investments must get information about transaction costs from those managing their scheme's assets and investments. Trustees and IGCs are

131 OECD (2013) *Financial literacy and inclusion: Results of OCED/INFE survey across countries and by gender*

132 The question on the calculation of interests asks: "Suppose you put $100 into a savings account with a guaranteed interest rate of 2% per year. You don't make any further payments into this account and you don't withdraw any money. How much would be in the account at the end of the first year, once the interest payment is made?" The follow-up question on compound interest asks: "and how much would be in the account at the end of five years? Would it be: a) More than $110 b) Exactly $110 c) Less than $110 d) Or is it impossible to tell from the information given"

133 European Commission (2015) *Consumer testing study of the possible new format and content for retail disclosures of packaged retail and insurance-based investment products*

134 The European Commission has announced it will extend the application date of the PRIIPs Regulation by one year. Its expectation is that the revised PRIIPs framework should be in place during the first half of 2017 and apply as of 1 January 2018.

135 Transaction costs are the costs and charges incurred as a result of the buying, selling, lending or borrowing of investments.

encouraged to report this information in as full a way as possible.[136] We recently launched a consultation paper on how transaction costs should be calculated, to ensure transaction costs are transparent and comparable so that oversight committees can make informed decisions.[137]

- **Annual management charges:** We heard that for segregated mandates there is no consistent definition of the annual management charge. Managers include different items within this charge, although trustees could request that charges are given in a comparable format as part of the tendering process.

- **DC products, hedge funds, private equity:** We heard that transparency was poor in defined contribution products and services, hedge funds and private equity. Some institutional investors suggested that increased intermediation for DC products made it difficult to get information on the underlying funds. Many institutional investors also said private equity and hedge fund charges were not always clear and transparent. We heard that some institutional investors avoided such products as a result.

- **Fiduciary management:** Fiduciary management services offered by investment consultants and fund managers were also areas identified as particularly unclear. We discuss this more in Chapter 8.

- **Publically available charges:** The actual charges institutional investors are paying are not in the public domain, only the headline charges, before any discounts have been negotiated. This presents challenges to institutional investors when benchmarking costs, making it a difficult and time consuming process and potentially prohibitively for those with limited resource).

4.67 More generally, the trustees that we interviewed suggested that it was difficult to find out the full costs of their investments, with larger investors potentially being more equipped to push for full cost information. Nevertheless, there are industry initiatives which, if successful, should help institutional investors to get access to comparable information. For example, the Investment Association is developing a disclosure framework for investment costs, which aims to create a standardised, fully Comprehensive Disclosure Code for asset managers to disclose investment costs.[138]

Most Favoured Nation clauses and confidentiality agreements hinder transparency, but they may provide benefits to investors

4.68 To understand whether there are barriers to institutional investors getting the information they need to make an informed decision, we explored whether 'Most Favoured Nation'[139] clauses and confidentiality agreements reduce transparency.

136 The Government's commitment to requiring greater disclosure of transaction costs is reinforced by Section 44 of the Pensions Act 2014 places a duty on the FCA and DWP to require the disclosure and publication of transaction cost information and administration charges. The FCA will be responsible for the rules to implement these measures for firms that it regulates and the DWP will be responsible for regulations in respect of occupational schemes. This requirement only applies to money purchase schemes. The rationale for this is that for defined benefit schemes the sponsoring employer already bears the scheme funding risk and should therefore already be more engaged in seeking costs and charges information. It is also expected that the new clarity about the definitions and information expectations should facilitate trustees across all types of schemes to engage more effectively with investment managers (even defined benefit schemes). See page 20 of the DWP and FCA joint Call for Evidence: Transactions Costs Disclosure: Transparency in Workplace Pensions (March 2015).

137 CP16/30: Transaction cost disclosure in workplace pensions www.fca.org.uk/publications/consultation-papers/cp16-30-transaction-cost-disclosure-workplace-pensions

138 Please see here for more information: www.theinvestmentassociation.org/media-centre/press-releases/2016/independent-panel-to-advise-ia-on-next-generation-disclosure-for-investment-costs.html

139 A contractual provision in which the seller promises the buyer that it will not offer another buyer better terms before offering those terms or better terms to the first buyer.

4.69 We found that confidentiality agreements tended to be between the asset manager and institutional investors. These agreements appear to be relatively common; 22% of respondents (mainly larger pension schemes) to our online survey had signed a confidentiality agreement. These agreements tend to capture the key terms and conditions and prevent institutional investors from sharing this information, especially where they have been given preferential terms. Asset managers appear to use confidentiality agreements for segregated mandates because they consider the terms and conditions are more sensitive. They may have more concern about this information being shared and so strengthening the negotiating position of current or prospective clients.

4.70 Many of the larger institutional investors that we spoke to felt they could refuse to sign a confidentiality agreement. They questioned whether smaller institutional investors, with less buyer power, would feel the same.

4.71 We recognise that keeping costs confidential may help some clients in their negotiations with asset managers. Introducing price transparency for institutional investors could mean that some investors are unable to negotiate the best deals as asset managers do not want to have to offer them to all clients. However, confidentiality agreements do not encourage price transparency and, where they exist, clients (typically smaller clients) may find it difficult to evaluate whether they are paying too much for their service.

4.72 Institutional investors may request Most Favoured Nation clauses. This requires the fund manager to tell the institutional investor if they offer the same products to other clients on preferential terms. These clauses may give these investors a better deal relative to other investors, and could help address concerns about lack of price transparency. However, we also heard that these clauses can make it harder to effectively negotiate with asset managers, as many managers with Most Favoured Nation clauses are unwilling to reduce fees.

4.73 The impact of such clauses is getting significant scrutiny under competition law. We do not currently have enough evidence of harm to propose changes in this area, but welcome any further evidence of the impact such clauses have on competition.

4.74 In summary, current regulations require that investors in funds get disclosure of most explicit costs and charges. Future regulations (in the form of the PRIIPs KID) will require the disclosure of an estimation of transaction costs. For segregated mandates there is less standardisation. New rules require the disclosure of transaction costs to pension schemes but other costs, including the annual management charge, are harder to assess and compare. Institutional investors are increasingly keen to understand fees and charges better and appear to be pushing asset managers for greater transparency and comparability.

Are investors able to assess when to switch product and provider?

4.75 For competition to work effectively, investors need to be able to assess whether their products have delivered value for money and switch if alternative products are likely to better meet their needs.

4.76 In this section we explore what costs investors could incur if they switch between funds and asset managers. We also consider whether there is information that helps investors judge whether or not to switch product and/or asset manager. We find that although there are no significant structural barriers to investors switching funds or providers, it is often difficult for investors to know whether they would be better off switching providers. In some cases we have found retail investors remaining in persistently poor performing funds.

Investors could incur a range of costs if they switch between funds and asset manager

4.77 Switching costs could be caused by regulations, tax, explicit charges or the time and effort it takes to switch between funds. We have explored whether such switching costs exist in practice.

4.78 There are some switching costs which are difficult to calculate, making it difficult for investors to know what they are likely to be. There can also be delays in switching between funds on different platforms which, when investors are aware of them, may reduce investors' incentive to switch.

4.79 The charges that investors can incur for switching between funds tend to include:

- Exit/redemption charges: this is an amount of money that may be taken from the investment before the proceeds are paid out. The charge might be affected by the investors' holding period.
- Bid-offer spread: if the investor is in a dual priced fund, a bid-offer spread might be applied, meaning that the value of their investments (the sell price) on redemption may be lower than the unredeemed value. With dual priced funds, there is a separate price for buying and selling units in the fund. The difference between the buying and selling prices is the bid-offer spread which broadly comprises the difference between the buying and selling prices of the underlying investments.
- Swing price: for single priced funds, a dilution levy[140] might be applied when the investor redeems their units, meaning that the value of their investments on redemption is lower than the unredeemed value.
- Initial charge: if investors switch money between funds, they may have to pay the initial charge for the new fund.
- Fees related to switching investment channel, such as between platform or adviser.

4.80 These charges are used by asset management firms to ensure that remaining unit-holders are treated fairly when others redeem and to reflect the administrative costs of the switch. However, some charges are difficult to estimate before redemption. For example, any dilution levy will depend on the movement in and out of the fund on the day the investor redeems. As a result, it can be hard for investors to estimate in advance what their switching costs are likely to be.

4.81 Any profits made from funds within a tax-efficient wrapper, such as ISAs and SIPPs, are free from capital gains tax. However, if a fund is held outside a tax-efficient wrapper, investors may be liable to pay capital gains when they switch funds. Depending on the investor's income tax band, they may also have to pay tax on dividends. Capital gains tax does not apply to investors switching within the same fund, for example if an investor switched to a post-RDR shareclass with a lower management fee or one that pays out dividends. However, in other cases, a capital gain may deter investors from switching between funds.

140 A separate, explicit charge that fund managers can choose to apply to specific client deals to cover any dealing or other costs they may incur when buying or selling shares in the fund.

4.82 Some direct retail investors have not considered switching and do not realise they can switch fund manager. In our survey, 37% of respondents had switched funds at some point, but 60% had not. Of those that had not, 70% had not considered it and 21% did not know it was an option. Investors may also be reluctant to switch, if it would involve crystallising a loss or cutting short a recommended holding period.

4.83 On the institutional side, we did not hear any significant concerns from trustees about the process of switching asset manager, although the resource and time required from trustees to run a manager selection process can be significant. Over the past five years, 65% of respondents to our online survey had switched asset manager within the same investment category at least once. The key reasons for switching included poor performance, change of asset allocation and/or investment consultant recommendation.

4.84 Around 65% of respondents that had switched asset manager (within the same investment category) said they found switching asset manager easy or very easy. However, 18% felt switching was hard. 30% of respondents had considered switching but had not done so. While the main reason was not being able to find a good alternative, other reasons were more positive such as the asset manager changing behaviour and/or improved performance.

There is limited information to help investors assess what to expect from their manager and to assess whether expectations have been met

4.85 We explored whether the information currently available to investors helps them to judge whether their fund is delivering against their expectations. If investors decide that their fund is not meeting their expectations and want to switch, they face the same challenges investors face choosing between funds.

4.86 Under current Collective Investment Scheme (COLL) rules, UCITS funds and non-UCITS retail schemes must publish an annual report. The fund's annual report details its investments and performance, and includes commentary from the fund manager about developments over the financial year. The annual report should provide investors with information to help them assess whether the fund is being managed in the way they have been promised and whether it is still appropriate for their investment needs.

4.87 We have recently removed the requirement to produce short reports, which were introduced in 2004 in order to summarise the most useful and relevant information about a fund's performance and activities during the time period under review. However, we received feedback that consumers did not benefit from the short report because of its format and complexity. Following our consultation[141], we have removed the requirement for AFMs of UCITS schemes and non-UCITS retail schemes to produce short reports[142]. While we have removed the requirement for firms to produce short reports, firms should be mindful of the information needs of consumers.

4.88 The annual and twice-yearly report gives investors information about how the fund as a whole has performed. However, there are no requirements for funds to provide a personalised statement or update about how investors' individual investments have performed, meaning that investors may not know how much their individual pot has grown or what individual charges they have paid.

4.89 Some funds that will voluntarily provide annual or twice-yearly personalised statements, but there is no specific obligation to do so. When investors are sent an annual statement,

141 Consultation Paper CP15/32: Smarter Consumer Communications: Removing ineffective disclosure requirements in our Handbook

142 Policy Statement 16/23- Smarter Consumer Communications: Removing ineffective disclosure requirements in our Handbook

this may outline the value of their investments and how the value has changed over the reporting year.

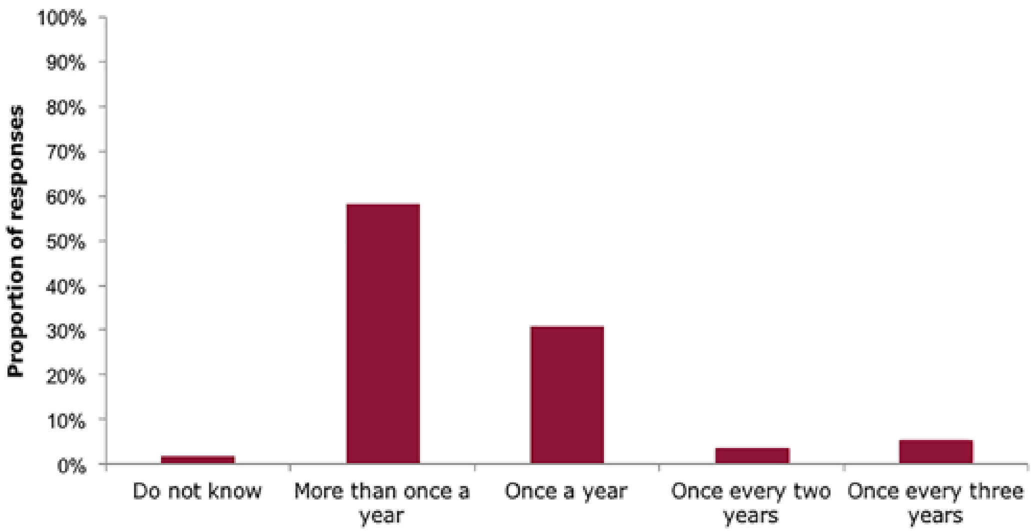
4.90 However, fund objectives ('Investment Objectives') are often not clearly explained to retail investors and it is sometimes difficult for them to assess what returns they can reasonably expect. We analysed the fund objectives of the funds in the Hargreaves Lansdown 150+ list in terms of the clarity of the fund objective. The results were mixed. Of the 39 funds we reviewed, 8 included a specific target in the fund objective and time period over which investors were advised to judge the success of the managers in generating returns. In contrast, other funds had objectives which were less specific, making it hard for investors to assess whether returns are reasonable.

4.91 We also looked at the clarity of the fund objectives of a sample of funds which showed only limited deviation from an index. When an asset manager is adopting a strategy with limited freedom from – and therefore has less chance of outperforming – an index they are required to disclose this to investors. However, we found that where this disclosure is made, the language used to explain these strategies can often be confusing, and believe most retail investors would be unlikely to appreciate the potentially low likelihood of these funds to outperform the market.

4.92 We recognise that asset managers may wish to allow for flexibility when outlining a fund's objectives, particularly during challenging market conditions. And further, that managers will need to outline a fund's limited freedom from the index and describe the strategy in a way that retail investors can clearly understand. Nevertheless, we consider this an area that merits further work to ensure greater clarity. In particular, we are interested in views about what can be done to make it easier for investors to understand what to expect from their asset manager and investment strategy.

4.93 Institutional investors tended to evaluate how their investments performed quite frequently, with around 60% of investors saying they evaluated asset managers more than once a year. Around 30% evaluated them once a year and 10% evaluated them less frequently.

Figure 4.9 – Frequency of evaluating asset managers



Source: Institutional online survey, see annex 5, figure 18
Sample base: 55 respondents; unweighted

4.94 The most common approach to assessing asset manager performance was for the institutional investor to carry out the analysis themselves, either against a benchmark or otherwise. Many relied on investment consultants to carry out evaluations, as well as reviewing annual reports prepared by their asset managers. Hiring a third party evaluator was less common.

4.95 Trustees told us that they sometimes struggle to scrutinise the performance of their investment portfolio as a whole, both in absolute terms and relative to the benchmark. We found that information presented to institutional investors about the performance of their investments was often presented in a format difficult for investors to understand and engage with. Quarterly reports for trustees put together by asset managers, sometimes with the help of the investment consultant, often include lots of information which can make it difficult for them to identify the important points they should be focusing on, so making it difficult to assess performance.

4.96 The most common measure used in evaluating performance was relative net performance. This was common across different size categories of institutional investors. However, smaller clients rated it as much more important than larger clients. For larger clients, ensuring asset managers managed the fund to the documentation (i.e. complied with their mandate) was rated as more important than for smaller funds.

Figure 4.10 – Ways in which respondents carry out evaluations

Source: Institutional online survey, see annex 5, figure 18

Sample base: 55 respondents; unweighted

4.97 In general, the quality of information available to pension trustees varies. We reviewed the quality of information reported to trustees by investment consultants and found inconsistencies in the quality of reporting to trustee boards. The quality tended to vary depending on the size of institutional investors. Those with more resources, or assets to use as a negotiation tool, seemed much better at ensuring information was provided in a comprehensive and clear way, working closely with consultants and asset managers to ensure high-quality, jargon-free reporting. Those with fewer resources have limited capacity to do this.

There are some barriers to switching platforms

4.98 We found that platforms are able and willing to take customers who want to switch, but keep their investments in the same fund. However, we are aware of some poor practice when platforms process switches. Our rules require firms to execute a client's request to transfer title to a retail investment product efficiently and within a reasonable time.[143] Firms should not impose unreasonable post-sale barriers on customers when they change product, switch provider, submit a claim or make a complaint.

4.99 In 2015 we identified a market-wide risk from the time it takes to transfer and re-registering investments between platforms or SIPP operators. To find out if delays are widespread in the industry, we reviewed transfer timing at broker dealer and wealth management firms with different operating models. We wanted to understand the retail client switching process when moving funds from or between platforms, including typical costs and timescales. We found a range of transfer times across the industry, some of which we consider represent a risk to effective competition. When transfer times are lengthy, consumers can be discouraged from switching providers because of excessive delays and potential exit charges. We believe that this is unacceptable and are currently considering possible mitigation strategies. Investors may incur other charges if they switch funds for example, those charges outlined in paragraph 4.75.

What impact do oversight committees have on investors' ability to get value for money?

4.100 We define oversight committees as the group of individuals that are responsible for making institutional investment decisions and ensuring they are carried out. There are two main types of oversight committee:

- **Trustee boards of pension scheme, charities and endowment funds:** a trustee is a person or company, acting separately from the employer, who holds assets in the trust for the beneficiaries of the scheme

- **Independent Governance Committees:** the role of IGCs is to represent the interests of DC pension scheme members by assessing the value for money of pension schemes and challenging providers to make changes where necessary

4.101 Trustees of pension schemes, and other types of oversight committees that oversee institutional investments, face a range of factors that limit their ability to make effective investment decisions. These include the low and variable levels of investment experience on oversight committees and resource constraints.

4.102 We also explored the impact of the size of oversight committees on their ability to negotiate with asset managers. We find that there is a relationship between some of the challenges facing oversight committees and their size, with smaller schemes (in terms of AUA and the number of trustees), generally being less well-resourced and knowledgeable. The amount of assets also affects oversight committees' bargaining position, with smaller schemes being less able to secure discounts from asset managers.

The ability of oversight committees to negotiate on behalf of investors varies

4.103 Most institutional investors, particularly trust-based occupational pension schemes and charities, have some form of oversight committee that makes the investment decisions. This committee is

143 See COBS 6.1G.1 in the FCA Handbook www.handbook.fca.org.uk/handbook/COBS/6/1G.html?date=2016-03-07

usually responsible for setting the investment strategy and objectives, asset allocation, types of strategies employed (mix of active versus passive) and choosing fund managers.

4.104 For contract-based schemes, in 2015 Investment Governance Committees (IGCs) were set up to represent the interests of scheme members in assessing the value for money of pension schemes, challenging providers to make changes where necessary. The FCA is reviewing the effectiveness of IGCs and will report on this in 2017.[144] We do not cover them further in this document.

4.105 Levels of experience on investment committee boards vary and in some cases trustees do not have significant investment experience. Around 30% of respondents to our survey suggested that there were no specific requirements (in terms of qualifications or experience) for trustees on their board.

4.106 Limited or variable experience on a board of trustees can result in:

- accepting investment strategies proposed by advisers without challenge
- delays to decision making
- limited consideration of asset allocation
- limited challenge of the charges incurred (discussed above)

4.107 In the UK, pension trustees are required to obtain and consider advice on their investments. Trustees usually fulfil this requirement by getting advice from investment consultants, although some larger schemes will have this expertise in-house. We discuss the role of investment consultants in more detail in Chapter 8.

4.108 Academic research[145] we commissioned suggested that trustees have a tendency to rely heavily on investment consultants, Chairs of Trustees and/or professional trustees that they perceive as having greater investment knowledge. This dependency can result in trustees accepting proposed investment strategies without critique or challenge. 33% of respondents to our online survey rarely challenged their consultant.

4.109 The lack of challenge appears to reflect a range of factors. These include the limited or different levels of investment expertise of trustee boards, the way in which trustees are trained and the amount of time available to challenge. We heard from trustees that training from industry participants can encourage dependence on investment consultants. We were also given examples of training materials worsening trustee fears, by highlighting the risks of them going against their investment consultant.

4.110 Trustee boards tend to meet once a quarter and have a lot of tasks to cover. In a few cases trustees were involved in setting the agenda, taking minutes, choosing the benchmarks and

144 Following its audit of legacy schemes, the Independent Project Board (IPB) made a series of recommendations, including a recommendation that the Financial Conduct Authority and the Department for Work and Pensions jointly review in 2016 industry progress in remedying poor value schemes. The Department for Work and Pensions and the Financial Conduct Authority are now undertaking this review and are working with providers to assess their progress in remedying poor value schemes. We intend to publish our joint findings in December 2016 and will write to firms thereafter with feedback. The findings from the Legacy Audit Progress Review will help inform (where appropriate) the Independent Governance Committees Effectiveness Thematic Review announced in the FCA's 2016/17 Business Plan.

145 Tilba, Baddeley and Liao (2016) *FCA Asset Management Market Study: Research Report on the Effectiveness of Oversight Committees: Decision-Making, Governance, Costs and Charge.* We commissioned this work to explore the dynamics of, and obstacles to effective investment decisions by oversight committees.

making the key investment decisions. One trustee was concerned that this made it more difficult to challenge their consultant as they were left with little time.

4.111 In addition, the research found that trustees often fear complexity and looking ignorant in front of their peers. This contributes to their unwillingness to challenge and makes them more likely to accept proposed strategies that they do not fully understand.

4.112 The varying or limited investment expertise on boards can cause delays to decision making. Where all or some members do not feel on top of a particular investment concept, trustees sometimes ask for more information and/ or training before agreeing to a particular strategy. While it is important that trustees do not rush into making decisions they do not understand, by the time all feel comfortable with the proposed approach the benefits of the strategy may be missed. Different levels of expertise on an oversight committee can also raise challenges for investment consultants and Chairs. It is difficult to pitch information at the right level to ensure all members can engage with the material and understand the key concepts.

4.113 How institutional investors decide to allocate their assets is an important decision which has a significant impact on investment returns. The amount of time spent by trustees on fund manager selection compared to asset allocation was highlighted as a concern by some chief investment officers and trustees. Some trustees we spoke to suggested the focus on manager selection was time-consuming and took trustees' attention away from strategic investment decisions such as asset allocation which is likely to have a bigger impact on returns than manager selection. An advisor mentioned that fund manager selection should be considered as an operational role, which trustees are not best placed to carry out.

4.114 Limited experience and resource constraints can also make it difficult for trustees to effectively scrutinise fund managers. Our online survey indicated that institutional investors tended to undertake negotiations directly with asset managers (59% of respondents undertook negotiations directly; for 34% of respondents negotiations were undertaken by the investment consultant). However, we heard negotiations are not always straightforward. One investor said that when they pushed back on costs, the fund manager simply re-packaged them, rather than reduced them. They had to go back and challenge the fees a few more times further before they were successful. A common theme is that when trying to negotiate on prices, asset managers will initially refuse to negotiate, but will do so when pushed. We expect that this is likely to be a particular challenge for trustee boards with limited resources, as they may not have the capacity to repeatedly do this. As a result, costs may be higher than they otherwise would be.

Larger institutional investors tend to be better able to negotiate with asset managers

4.115 The demand side of institutional asset management is fragmented. In January 2016 there were 24,730 defined contribution trust based schemes and 5,240 defined benefit schemes. However, defined contribution workplace contract schemes appear to be less fragmented than defined contribution trust based schemes. The former represents 40% of active members but only 6% of all schemes and the latter represents 37% of active members but 79% of schemes.

Figure 4.11: Population of pension schemes in the UK[146]

	Defined benefit	Combined DB/DC: mixed benefit	Combined DB/DC: dual section	Defined contribution trust based schemes	Defined contribution (workplace contract)	TOTAL
Schemes	5,240 (12%)	240 (1%)	980 (2%)	24,730 (79%)	2,500 (6%)	43,690 (100%)
Open Schemes	800 (3%)	30 (1%)	470 (2%)	27,000 (88%)	2,270 (7%)	30,570 (100%)
Active members	1,255,000 (12%)	30,000 (0.3%)	1,151,000 (11%)	3,883,000 (37%)	4,174,000 (40%)	10,493,000 (100%)

4.116 There appears to be a general trend that the larger the pension scheme, the more trustees are likely to have:

- investment expertise and resources to spend helping them make investment decisions
- greater bargaining power and ability to benefit from economies of scale

4.117 Qualitative research carried out in 2016 by the Pensions Regulator found that 67% of professional or corporate trustees on large schemes had a professional qualification in finance or investments, compared to 51% for smaller schemes.[147] In 2014, they also found that 76% of the larger pension schemes had a training plan in place for trustees, compared to 29% for smaller schemes.[148] These findings suggest that those who serve on larger oversight committees are likely to be more professionally qualified and better trained. In addition, our online survey found that the largest schemes tended to have larger investment oversight committees. A large proportion of schemes with over £1bn in assets had six or more members on their oversight committee (84%). For smaller investors, with less than £50m in assets, only 2% have 6 or more members.[149]

4.118 In addition to differences in experience and expertise, the scale of assets held by institutional investors matters when it comes to negotiating with asset managers. Analysis of our institutional online survey found an inverse relationship between the level of fees paid and the size of assets institutional investors held in their largest mandate/ fund.[150]

4.119 When negotiating with asset managers, institutional investor's bargaining power is likely to be based on the scale of the funds they control relative to the size of the asset manager. Asset managers are likely to want to attract larger schemes because absolute profits are greater and the potential for economies of scale can further improve profitability across their portfolio of funds.[151] We see this in firms' pricing structures whereby the larger the assets under management, the lower the percentage of assets under management charged to the scheme (in the case of DB pension funds) or the members (for DC pension funds).

146 The pensions regulator data based on scheme returns (1 January 2016)

147 OMB Research prepared for The Pensions Regulator (2016): *Trustee Landscape Qualitative Research*. www.thepensionsregulator.gov.uk/docs/trustee-landscape-qualitative-research-2016.PDF

148 GfK Financial prepared for The Pensions Regulator (2014): *Occupational scheme governance: a report on the (eighth) scheme survey.* www.thepensionsregulator.gov.uk/docs/governance-survey-report-2014.pdf

149 See annex 5

150 See annex 5

151 See annex 8 for our analysis of firm profitability

4.120 It is likely that smaller pensions schemes could achieve significant cost savings from consolidating their assets. LCIV is an example of the kind of benefits that can be achieved.

Benefits of consolidation: the London Local Authorities

31 London local authorities are currently involved in setting up the London Collective Investment Vehicle, which has established a UK-based Authorised Contractual Scheme fund (ACS Fund). This umbrella fund offers a range of sub-funds, which provides participating authorities with access to a range of asset classes that they require to implement their investment strategies.

The LCIV expects to introduce nine sub-funds, which will account for £6.1bn or around 23% of the boroughs' total assets under management (20 of the 31 participating authorities).

For these funds they expect the total fee savings, from reduced investment management charges alone, to be a minimum of £2.8m a year.

Additional cost savings are expected as they move to a wider and more expensive range of asset classes (alternatives) and strategies (active), as there are usually more opportunities to make savings than in plain 'vanilla' passive funds where prices are already low.

They expect to make more savings as their scale means they can better able negotiate the entire spectrum of investment costs, including reduced custodian fees and lower procurement costs.

They expect this model to help them improve their expertise at all levels.

Source: Local Government Pension Scheme: Investment reform criteria and guidance – response of FEB16

4.121 However, even though there may be benefits to scheme members from consolidating pension schemes, there are challenges and incentives that work against consolidation happening in the medium term.

4.122 Employers, often as a result of mergers and acquisitions, can have multiple schemes which would benefit from pooling together and strengthening their bargaining power. As part of our interviews, we asked what the barriers to scheme amalgamation were, and interviewees suggested that amalgamating schemes with different objectives and funding levels is challenging and costly to the employer in the short term. Therefore there is no appetite to initiate this, even though it may benefit both the scheme and the employer in the long term.

4.123 In addition, there could be benefits for schemes across employers to consolidate their assets. Again we heard employers are reluctant to join together. In particular, we heard that trustees present a potential obstacle. This is because by voting to consolidate their assets, they could make their role redundant.

4.124 Other jurisdictions (Australia and the Netherlands) have identified this as a concern and supported schemes to achieve scale. The Dutch pensions supervisor, De Nederlandsche Bank (DNB), has raised the bar for board expertise and integrity, by introducing an extensive new governance structure and is set to pass new legislation for pensions communication. Since the end of 2005, the total number of pension funds in the Netherlands has dropped from 800 to 365, and this trend does not show any sign of slowing. In 2010, Joanne Kellermann, then director of supervision at DNB, argued that 100 funds should be sufficient. By far the largest reduction occurred among company pension funds, whose number has fallen from 710 to 279.

4.125 In the UK, we have seen some developments in the market, which work to address fragmentation of demand. For example, fiduciary management arrangements and master trust offerings allow providers to pool the assets of their clients in order to achieve good deals with fund managers. However, the extent to which investors are benefitting from scale is not always evident. Most fiduciary managers charge a percentage of asset under management on top of the asset management fees, which potentially reduces the cost savings from pooling assets.

Questions for discussion and next steps

4.126 This chapter has looked at how investors choose between asset managers. We will continue to analyse:

- the drivers of fund flows
- the relative performance of 5-star funds and passive funds
- the performance of funds on best buy lists and performance relative to funds available on a given platform

4.127 We would welcome feedback, in particular, on the following areas:

- **Confidentiality clauses and MFNs:** at present we do not have sufficient evidence to propose changes in this area, but we welcome any further evidence of the impact such clauses have on competition

5.
How do intermediaries and fund governance bodies affect competition between asset managers?

We considered the role of intermediaries and fund governance bodies and the extent to which they act in the investor's interests. We find that:

- Retail platforms can secure discounts on fund charges but this practice is not widespread. It is not clear that retail investors benefit fully from the economies of scale available to platforms.
- Investors can incur a range of different platform charges and incentive payments, potentially making it difficult to understand the full cost of investment.
- Platforms represent an important route to market for new funds and managers, and perform useful due diligence.
- Within the advice market, vertical integration of advice and fund management in some firms, the growth of model portfolios and the role of third party rating providers all raise questions about competition dynamics and value for money.
- Fund governance bodies, whether in-house or outsourced, lack independence from the fund managers and do not appear to exert effective challenge on value for money.

There is a case for further FCA work on the issues relating to intermediaries raised in the chapter, and we welcome views on this.

Introduction

5.1 The previous chapter considered how retail and institutional investors make choices, whether they are able to identify managers that are likely to deliver value for money and whether investors switch away from funds that persistently underperform.

5.2 Both the retail and institutional asset management sectors are heavily intermediated. Institutional investors, particularly pension trustees, themselves act as agents on behalf of underlying investors. They will typically be advised by an investment consultant on both the appropriate investment and asset allocation strategy, and manager selection. Retail investors may make investment decisions with the help of platforms or advisers who, in turn, may use an adviser platform to execute their client's investment decisions.

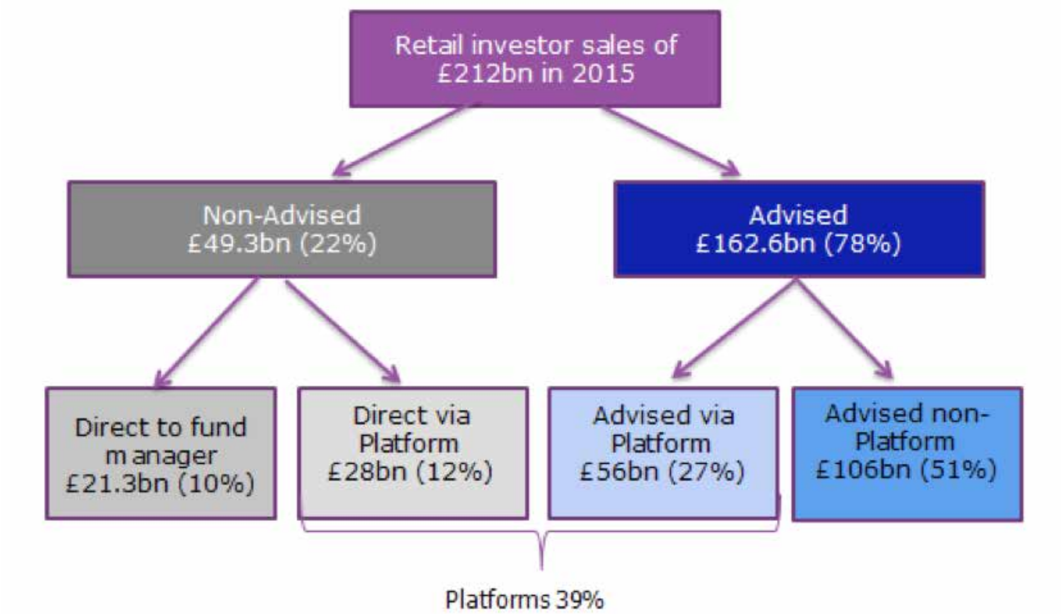
5.3 In this chapter we consider the role which platforms, financial advisers, third party rating providers and fund governance play in investors' ability to get value for money, and whether intermediaries act effectively on behalf of investors. We cover investment consultants in Chapter 8.

5.4 In doing so, we consider the following questions:

- What impact do platforms have on fund charges?
- What impact do platforms have on the total cost of investment?
- Do platforms create barriers to asset managers gaining routes to market?
- What impact does the financial advice market have on competition between asset managers?
- Do fund governance bodies consider value for money on behalf of investors?

5.5 Retail investors may invest and access asset management services through product 'wrappers' (including pension and ISA wrappers). They may access products and funds directly, through a 'Direct to Consumer' platform, or through financial advisers who help execute investment decisions and may in turn access investment products through a platform. As illustrated in Figure 5.1, in 2015 an estimated 39% of gross retail sales were made via a platform, and D2C platforms now account for more non-advised sales than sales made directly with the fund manager. Advised sales still remain substantially larger than non-advised sales at an estimated 78% of gross retail sales.

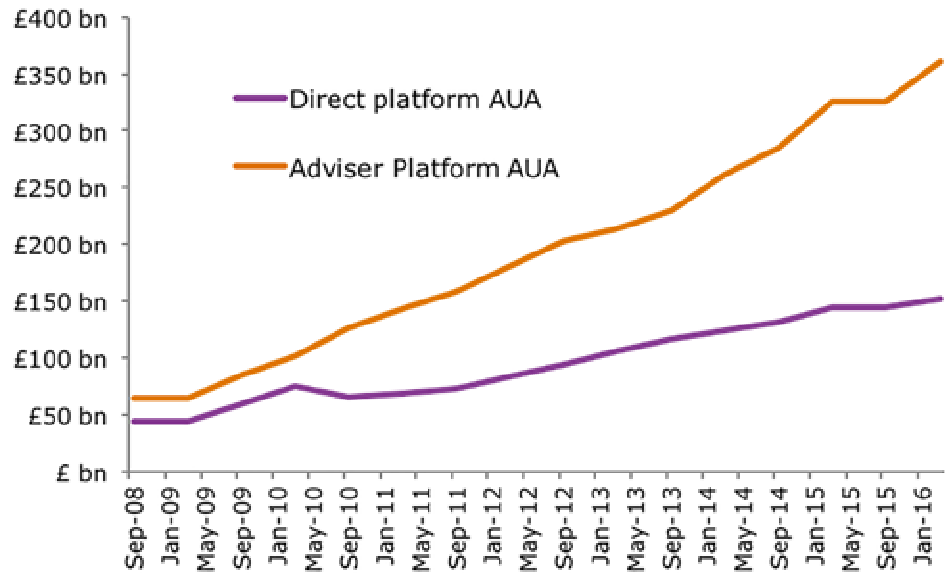
Figure 5.1 – Gross retail sales in 2015 – overall distribution split[152]



152 Gross Sales based on IA data. Direct includes sales through a sales force or tied agents and private client sales of own funds. The IA estimates that flows through platforms are 1/3 direct to consumer and 2/3 advised.

5.6 Nevertheless, direct to consumer (D2C) platforms are an increasingly important part of the distribution chain for retail investors. In the six months to 31 March 2016, D2C's showed asset growth of 5.1%.[153] As illustrated in Figure 5.2, at 30th March 2016 D2C platforms held £152 billion of assets. Financial advisers can also use platforms to access funds on behalf of their clients and, at the end of March 2016, over £360 billion of assets under administration were held on adviser platforms.[154]

Figure 5.2 – Growth of assets under administration on direct to consumer and adviser platforms.[155]



What impact do platforms have on fund charges?

5.7 We have looked at the impact platforms have on the price of funds available to retail investors. By aggregating assets under management and negotiating directly with asset managers, platforms could have a positive effect on competition between asset managers and the fund charges paid by retail investors.

Platforms can negotiate discounts on fund charges, by these do not appear to be widespread

5.8 Asset managers told us they value the larger and more predictable fund flows through platforms. They may therefore be willing to discount fund charges and wave initial charges or minimum investment thresholds on the funds and share classes available through platforms. While this is not always the case, for example some funds available on some platforms impose initial fund charges[156], overall the fund charges on platforms are likely to be lower than the charges available to investors who invest directly with asset managers

153 Source Platforum UK *D2C Guide: Direct Platform market update* (July 2016). For context there was a 1.5% increase in the FTSE Allshare over this period.

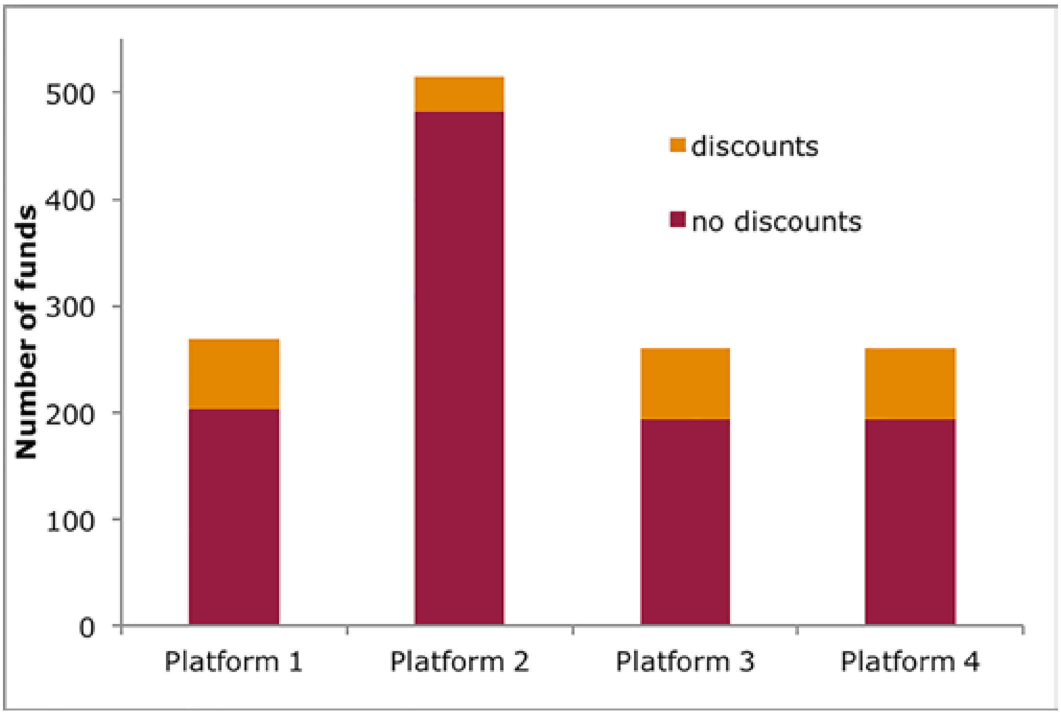
154 Platforum UK *Adviser Platform Guide Issue 26* (June 2016)

155 Source Platforum *UK Adviser Platform Guide Issue 26* and July 2016 market and *UK D2C Guide: Direct Platform market update* (July 2016).

156 We found examples of popular funds which impose initial charges of up to 5% AUM.

5.9 Some platforms are more successful than others in negotiating discounts. Some execution only platforms in our sample had no discounts on any funds whereas another platform had discounts on 11% of funds available. Figure 5.3 illustrates how even for platforms which actively secure discounts, in most cases, asset managers do not appear to offer extensive OCF discounts on many of their funds.

Figure 5.3 – The number of UK Equity funds with discounts available on different platforms.[157]

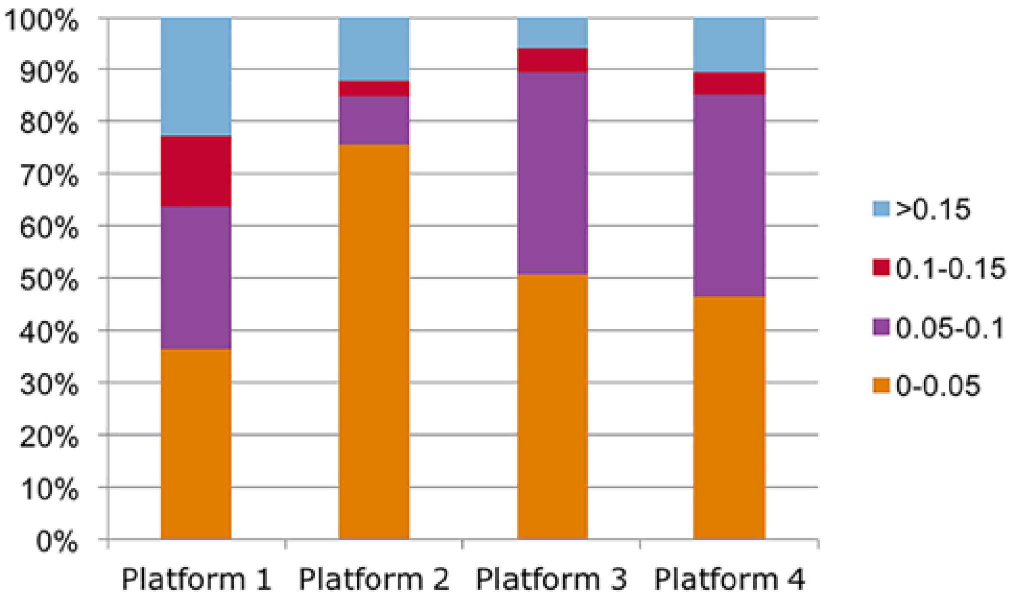


5.10 When platforms do secure discounts, they are not generally very large. We analysed the discounts available on four platforms' UK equity funds. The results are shown in Figure 5.4 and show that at least 75 per cent of the discounts across the four platforms were below 15 bps. However, in some cases the discounts can be substantial, up to 38 basis points in this sample.[158]

157 Data is at share class level and so may overstate the number of discounts available. For example, where the same discount is offered for income and accumulation share classes of the same fund. We have attempted, where possible, to treat super clean share classes as a discount.

158 We have seen larger discounts on other platforms.

Figure 5.4 – The ranges of discounts available on different platforms for UK equity funds[159]



5.11 When asset managers do offer a discount, it is likely to be because they consider the platform will generate flows of money into the fund. For example, one asset management firm in our sample had recently created a new share class with a reduced AMC for a specific platform. The firm has not offered other platforms access to this share class, including its own group platforms. The firm said this was because they believed that giving the platform a special shareclass would generate significant new volumes. They also felt that, as the platform had specifically committed to promote the fund in one of their ISA campaigns, a reduced price was justified.

5.12 While the majority of funds listed on platforms are not discounted, retail investors can still benefit if they choose funds that are. Platforms in general give access to best-selling funds which may not be available directly from the asset manager or would be more expensive, for example, because of an initial charge. However, while platforms can offer a cheaper route to accessing best-selling funds, there is often no significant difference in the prices of best-selling funds across different platforms. To get some insight into the extent to which best-selling funds are priced differentially, we looked at the price of best-selling funds which appeared in the top 10 best sellers on two or more platforms for 2015. As illustrated in Figure 5.5, of the nine funds that were best sellers on more than one platform, five were priced the same and the remaining four were only priced differently on one platform.

159 The analysis compared the OCF charge (including rebates) on four D2C platforms against the headline OCF charge in Morningstar

Figure 5.5: the range of fund charges for platforms' best-selling funds, August 2015.[160]

	Highest fund charge	Lowest fund charge
Fund 1	97	97
Fund 2	75	60
Fund 3	92	87
Fund 4	83	83
Fund 5	117	90
Fund 6	103	103
Fund 7	90	86
Fund 8	88	88
Fund 9	84	84

5.13 Platforms can offer cheaper access to funds than going directly to an asset management firm or through an adviser. However, it does not appear that OCF discounts are common, even on best-selling funds. Although some discounts are available on some funds it is likely that they are not that sizeable when viewed at the level of the investor's total portfolio and compared to the overall costs.

What impact do platforms have on the total cost of investment?

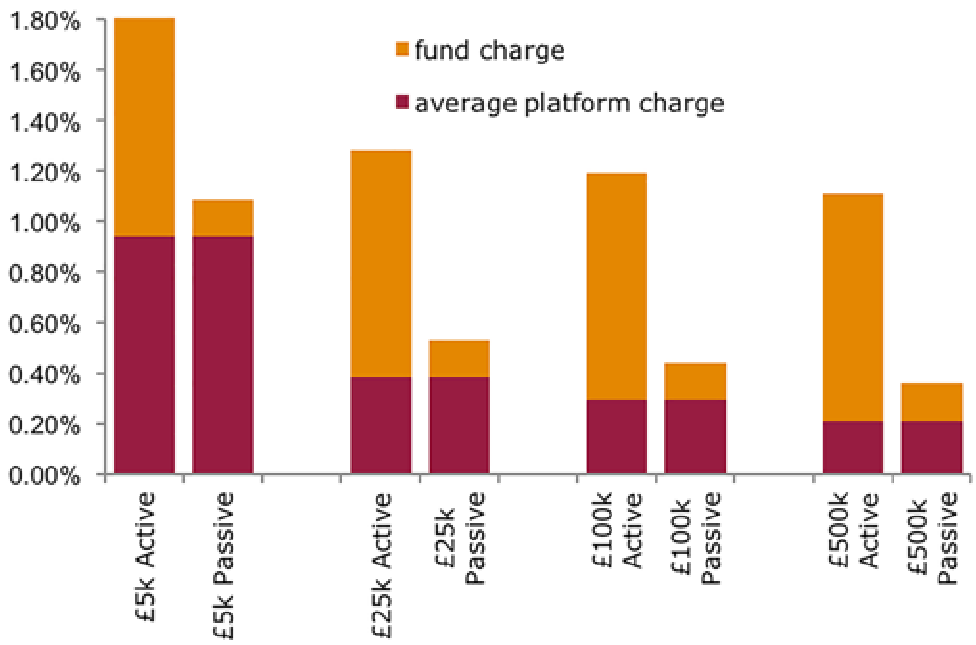
5.14 We wanted to understand the impact of platform charges on the total cost of investment. The size of platform charges relative to fund charges depends on the type of fund investors choose and the size of their investment pot.

Platforms can have a significant impact on the total cost of investment

5.15 From the data we collected, for most actively managed funds, the fund charge was still the biggest contributor to the overall cost of investment. However, platform charges can contribute a larger share to the total cost of investment for investors using passive funds. Figure 5.6 shows platform charges tend to contribute to a decreasing share of the total cost of investment as investor pots grow.

160 This analysis looked at the fund charges of six platform's top 10 best-selling funds for 2015. Of the 60 best-selling funds, nine were in the best-selling list of more than one platform and we compared current prices for these funds across the six platforms.

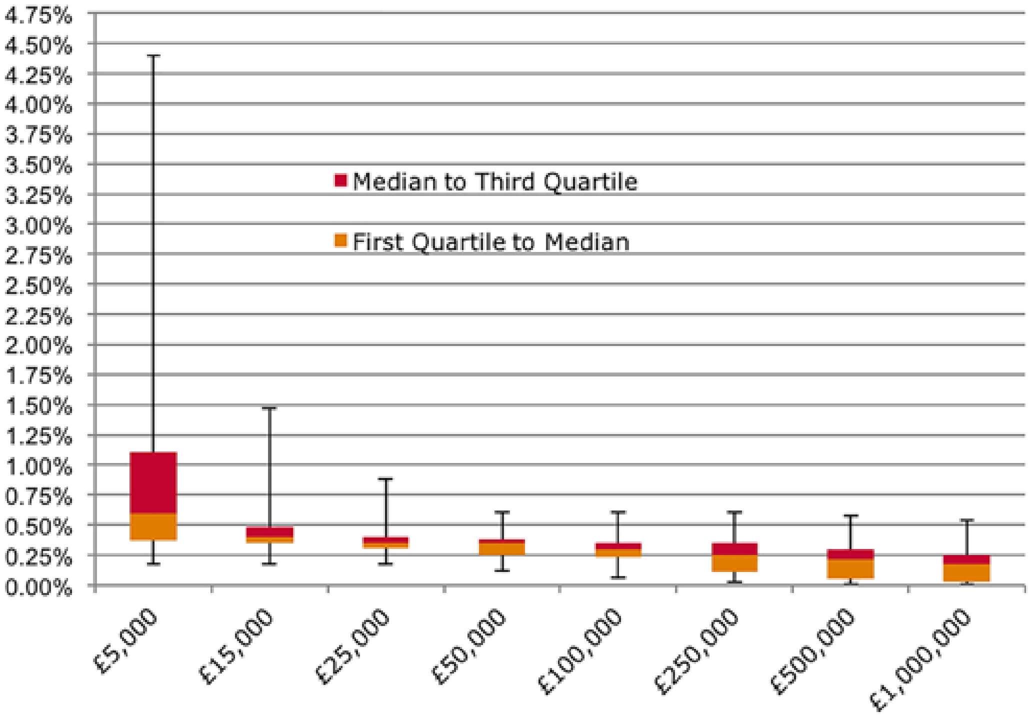
***Figure 5.6: Average platform charges for ISA/General Investment Account retail investors with different pot sizes*[161]**



5.16 Figure 5.6 illustrates average platform charges. Figure 5.7 shows the charge ranges; different platforms may offer additional functionality or services of value to consumers, which may justify higher charges. Nevertheless, the range of different platform and, to some extent, fund charges means that the total cost can vary significantly depending on which investment route investors choose.

161 Source Langcat. Average platform charge is based on 27 platforms. Fund charges are AUM weighted average figures for retail clean UK large cap equity share class OCFs from Morningstar; 0.90% for active and 0.15% for passive.

Figure 5.7: The range of platform charges for ISA/GIA retail investors with different pot sizes[162].



Source – based on Langcat data.

5.17 We wanted to further explore how the total cost of ownership can vary depending on the distribution channel chosen. We asked the platforms in our sample to price a three year monthly investment of £100 and a £50,000 lump sum investment in the Blackrock fixed income global opportunities fund, including platform fees but excluding adviser fees.[163] We chose this fund because it was a popular fund over the relevant period. The cost of ownership varied from £56 to £271 for investors making regular saving and from £1,254 to £4,189 for a lump sum investment.[164] The most expensive was an adviser platform which had both the highest OCF for the fund and a 5% initial fee, although the larger OCF was a pre-RDR bundled share class and so may include some adviser remuneration. In this example, the fund charges were the most significant factor in the overall cost of ownership.

5.18 Platform charges are not always correlated with fund charges, so selecting the cheapest fund may not lead to the cheapest overall investment cost. Figure 5.8 below illustrates the overall charges for a medium risk rated portfolio solution for a £50,000 investment (based on Langcat data). It shows that platforms with a low charge do not necessarily offer the lowest cost for investors looking for model portfolio[165] solutions. For example, The Share Centre has the lowest platform fee but the most expensive fund charges for its mid-risk solution. Conversely Simply EQ has the highest platform fee but one of the cheapest fund charges on its solution

162 Source – based on Langcat data. The middle coloured box illustrates the middle 50% of charges for the pot size and the line that divides the box into two parts represents the median for each pot size. The black lines show the maximum and minimum charges for each pot size

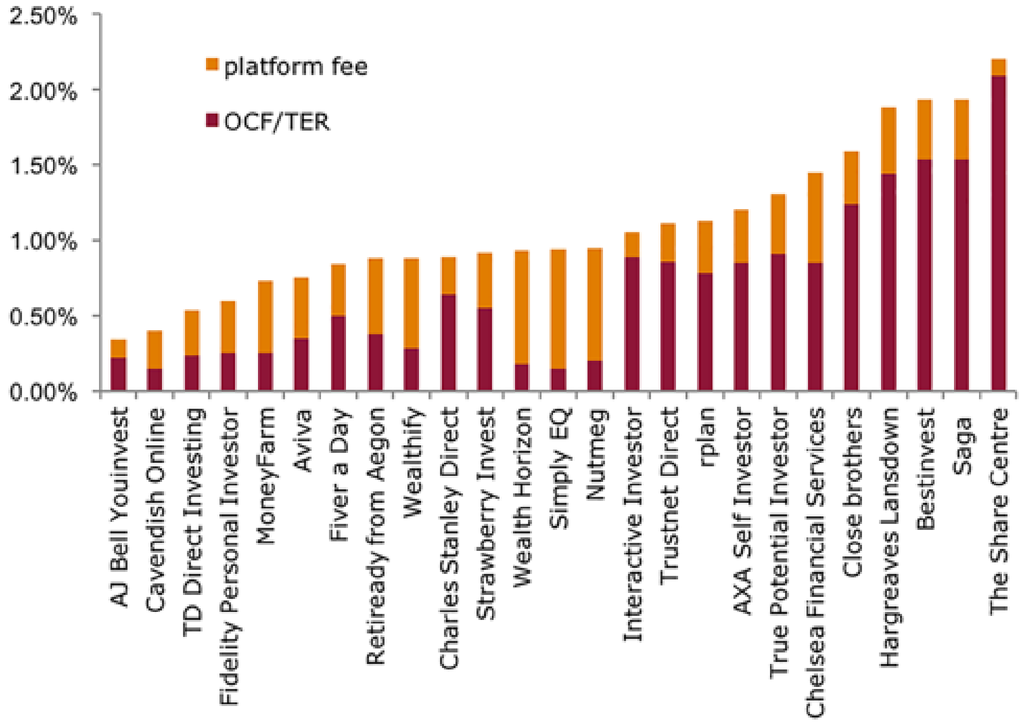
163 The fund performance was assumed to be 5% to make comparison easier.

164 Does not fully reflect the other charges which can form part of the overall cost of ownership for retail investors

165 A selection of investments designed by firms as 'off the shelf' solutions to meet different risk profiles and investment objectives.

portfolio.[166] These differences suggest that investors cannot rely on fund or platform charges alone to give a reliable indication of the total cost of investment.

Figure 5.8: Breakdown of total cost of mid-risk rated solutions offered by D2C platforms for a £50,000 investment[167]



5.19 We have identified a range of different charges that apply to investors' pots. This can make it difficult for investors to both compare the value of different investment channels and to understand the total cost of their investment. Figure 5.9 lists a variety of charges which are applied by different D2C platforms and shows the complexity in calculating a likely platform fee. It may underrepresent true complexity, as overall costs will depend on the customer's fund choices, the extent to which the platform has negotiated a discount on the fund OCF and other charges taken from the fund such as transaction costs.

166 Note: These are indicative portfolios and do not necessarily offer the same level of service for example some include portfolio rebalancing. Likewise the platforms may offer a different service quality, functionality and breadth of offering.

167 LangCat: *Come and have a go: rise of the Machines- Direct platform investing in the age of robo-advice*

Figure 5.9: Potential charges incurred and incentives offered on D2C platforms

Core charges	Product and circumstance specific fees	Circumstance specific charges	Incentives
% AUA fee	Charges for drawdown	Different costs for phone and on-line transactions	Cashback
Flat fee £	Charges for wrappers	BACS payment fees[162]	Waived platform fees for a year
Capped maximum fees	Annuity purchase fee	Exit fees / Closure fee	Avios (Airmiles) points
Fees inclusive of trading	Charges by account	Charges for corporate action notification	Free gifts
Transaction charges	Pension splitting on divorce charge	Charges for printed valuations	Free chat
	Arranging death benefits charge	Charges to transfer cash / stock to another provider	Discounted fund charges
	Government Actuary's Department calculations		

5.20 We have conducted some analysis on the information provided on platform charges. Based on the information we have reviewed we believe that most platforms (particularly D2C providers) correctly disclose charges to the customer before the point of sale. A gap remains, however, at and after the point someone becomes a customer of the platform. From this point, it is a challenge for the consumer to separate, aggregate or evaluate charges, particularly in the context of overall performance. We are also concerned about the volume and range of different charges which can potentially add so much complexity and detail that consumers cease to engage with the information.

Do platforms create barriers to asset managers gaining routes to market?

5.21 Platforms can offer asset managers a cost effective gateway to the retail market and so benefit competition in the sector. This is likely to be particularly beneficial for smaller fund managers with a more limited marketing budget or brand awareness.

5.22 However, platforms could have a detrimental impact on competition between asset managers if they create barriers which affect their ability to compete. There are two main ways platforms could favour certain funds which, in turn, may distort consumer choice. Platforms could give preference to their own in-house funds or to certain fund managers in their lists or promotions.

Platforms do not create significant obstacles to asset managers gaining routes to market

5.23 No stakeholders raised concerns about platforms systematically giving preference to certain fund houses. The aim of the RDR was to limit the extent of bias in the funds that platforms and advisers promoted because of commission payments. The post-RDR implementation review found that, following the RDR, the sale of products which had higher commissions has declined and the sale

168 A fee to make electronic payments.

of retail investment products which paid lower or no commission pre-RDR has increased.[169] This analysis took place before the introduction of the RDR platform rules in April 2014. As a result, the change was attributed to changes in adviser recommendations, as adviser rules came into effect in January 2013. Nevertheless, the RDR is likely to have had a similar effect on platform flows.

5.24 Generally, the asset management firms in our sample did not report major challenges getting their funds listed on platforms. However, some platforms face technological challenges listing certain fund types. For example, some platforms are reluctant to list investment trusts (ITs) due to concerns about liquidity and difficulties operating the fixed or tiered fee structures typical in closed-ended funds such as ITs. However, other platforms do have the capability to offer ITs.

5.25 The platforms in our sample generally said they preferred daily dealing funds[170]. One platform responded that daily dealing was a hard requirement whereas others said exceptions could be, and were, made and that this required manual intervention due to their system capability. Therefore, some platforms do seem to have some technological limitations and these could inhibit product innovation and restrict consumer choice. Although consumers can generally access most products through a different platform or different distribution channel, we will continue to listen to industry concerns in this area.

5.26 The criteria platforms use to decide which funds to put on a best buy list can vary but are generally based on standard metrics. Metrics may include:

- **Portfolio characteristics** such as maximum drawdown and maximum loss.
- **Investment processes** operated by the fund manager/firm.
- **Tenure** of the fund manager, which tends to be reviewed across at least a three year period.
- **Adherence to fund objectives.**
- **Fund pricing** generally compared to similar style and performing funds
- **Past performance**, including consistency of performance. Part performance could cover absolute performance over 3 years + and risk adjusted return over 3 years +. Past performance could be looked at through quartile rankings over discrete and cumulative time periods.
- **Independent ratings** by research agencies that conduct quantitative and / or qualitative analysis.

5.27 While respondents did not raise concerns about the criteria used to determine which funds get listed, some asset managers had concerns about the process platforms use to decide which funds to include on a best buy list. One respondent suggested that preference was given to specific clients, including those managers with which the platform already had a relationship, rather than continuing to expand the number of funds and managers on the platform best buy list. Another suggested that certain fund managers could leverage their position in the market to get more detail of how platforms put together their best buy lists and could get more 'face to face' time with platform managers which gave them a better chance of convincing platforms to put the fund on the list. However, these concerns did not appear to be widespread. Some asset managers suggested that platforms selected funds they could put on their best buy

169 FCA: *Post-implementation review of the Retail Distribution Review – Phase 1* (2014) www.fca.org.uk/publication/research/post-implementation-review-rdr-phase-1.pdf

170 Daily-dealing funds are pooled investment vehicles whose units or shares can normally be traded every working day

list and then negotiated a reduction in fund charges, with some managers being prepared to offer discounts for specific platforms.

5.28 We have looked at whether platforms give prominence to their own in-house asset management products. Not all platform providers offer their own funds and non-integrated asset managers still have opportunities to access routes to market. However, 7 out of the largest top 10 platforms have an in-house or in-group asset manager.[171] For D2C platforms the proportion of AUA in in-house funds varies widely across different platforms. The proportions are falling for D2C platforms with a legacy direct book of customers. Nevertheless, the number of vertically integrated providers is increasing[172] and so vertical integration is likely to become an increasingly widespread feature of the non-advised retail sector.

5.29 The vertically integrated firms in our sample had a significant share of AUA and clients in in-house funds. For example, one platform in our sample had 52% of its AUA in its own in-house funds and another had 44% of its AUA in in-house funds. There can be valid reasons for this. For example, a manager with a large legacy book of direct consumers or a strong fund management brand could generate a high proportion of in-house fund AUA.

5.30 Vertically integrated platforms overall do not appear to give significant prominence to their own funds in best buy lists.[173] There were three vertically integrated firms in our sample, one firm had 14% per cent of their own funds in their recommended fund list, with the other two having no in-house funds on their lists.

Figure 5.10: The number of in-house share classes on best buy lists

	Dec-15			Dec-14		
	Best Buy List	**In-House**	**% In house**	**Best Buy List**	**In-House**	**% In house**
Frequency	304	19	6.3%	315	21	6.7%

5.31 We asked platforms to give us overall costs for customers in their best-selling funds and in their best-selling in-house funds, where applicable. Overall fees were fund-dependent and there was no consistent increase or decrease in the overall costs paid by the in-house fund investor. One vertically integrated provider's in-house funds had an average OCF of 0.91% compared to 0.80% for the external funds on the same list. A lower proportion of in-house funds had discounted OCFs compared to external funds on the best-buy list. However, this provider also offered some of the cheapest in-house funds and included these as part of their solution portfolios, so this example does not show a clear trend towards promoting expensive or poor quality in-house funds.[174]

5.32 Similarly, when platforms use in-house funds in model portfolios/solutions, they do not appear to be more expensive. Figure 5.11 below plots fees for three vertically integrated D2C platforms which offer multi-manager funds. It shows that although the absolute level of OCF for these funds is high they are comparable to other multi-manager funds.

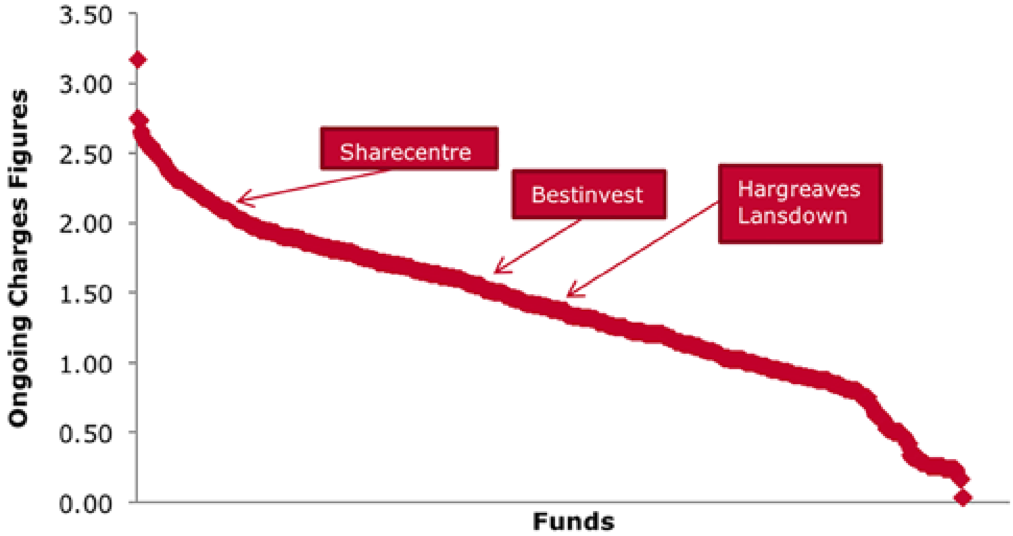
171 Based on Platforum AUA figures as at 31st March 2016 and desk based research

172 For example Santander launched in June citywire.co.uk/money/santander-launches-investment-platform-for-isa-customers/a921285

173 Our research has not encompassed other forms of promotion such as mail based advertising or analysis of website design.

174 We have not evaluated the quality of in-house products compared to peers.

Figure 5.11: 2015 OCF for Multi manager funds, including multi manager funds offered by platforms[175]



5.33 Overall, it appears platforms enable rather than hinder access to market for asset managers. Platforms provide due diligence on the governance and investment processes of the funds they list and some platforms only list funds with a track record. Some stakeholders raised concerns that the need for a track record creates barriers to entry and expansion for small firms. However, we do not regard a track record requirement as unnecessarily restrictive. Additionally, the due diligence processes provide a check on the quality of funds being made available to investors, which is particularly useful for D2C customers who do not have an adviser doing this for them.

5.34 Some rules about communications and disclosures may create barriers to innovative solutions which improve disclosures or the way investors are presented with information. One example is our approach to social media, which requires all promotions to be standalone compliant. Providers and distributors told us that the requirement for tweets, internet search text and banners to include risk warnings makes social media difficult to use.[176] More generally, our financial promotion rules were also raised as an issue in roundtables. We have fed these findings into our work on Smarter Communications.[177]

What impact does the financial advice market have on competition between asset managers?

5.35 Financial advisers play an important role in retail distribution, with nearly £163bn of gross retail sales in 2015 being advised. The financial advice market is a mix of smaller advice firms and larger networks.[178] Financial advisers offer either restricted advice (where the adviser can recommend

175 Morningstar

176 Individual posts have to carry the necessary risk warnings. In the asset management sector the relevant risk warning rules are COBS 4.2.4 which state that 'a product or service that places a client's capital at risk must make this clear' and 'a product or service that quotes a yield figure gives a balanced impression of both the short and long term prospects for the investment.'

177 FS16/10 *Smarter Consumer Communications feedback statement* www.fca.org.uk/publication/feedback/fs16-10.pdf

178 'Networks' are firms with 5 or more appointed representative firms, or with appointed representatives who have 26 or more individual advisers between them. www.fca.org.uk/firms/appointed-representatives-principals/networks

a limited range of products or providers as defined by the restriction) or independent advice (where the adviser considers the full range of products and providers in the market).[179]

5.36 We have not conducted an in-depth review of the impact financial advice has on competition between asset managers as part of this market study. This is because there has been significant regulatory scrutiny of the financial advice market in recent years, including through the Retail Distribution Review and the Financial Advice Market Review. Nevertheless, there have been recent developments in the financial advice sector which may affect competition between asset managers, which we outline below.

5.37 We have looked at the following recent developments:

- **Adviser networks and vertical integration:** adviser networks and other vertically integrated firms offering in-house funds and investment products. A number of firms including St James's Place, Hargreaves Lansdown, Old Mutual and Standard Life operate both an advisory and asset management business. Adviser networks are offering asset management products and many asset managers are looking at developing or purchasing online and/or face-to-face advice services which offer consumers advice on these products.

- **The growth of model portfolios:** asset managers and intermediaries are increasingly offering model portfolios, designed to meet consumers' risk and investment objectives. These portfolios are increasingly used by financial advisers to help match their clients' risk profile and investment objectives to a suitable investment (see below).

- **Third party ratings providers:** financial advisers use third party rating providers to assess whether funds would be suitable for their client. Advisers may not realise that ratings are not 'whole of market' and that some ratings agents have a conflict of interest as asset management firms pay them a fee to use ratings in marketing material and to access other services.

5.38 We explore the potential implications of these market developments for competition between asset managers below.

Features of the retail advice market have an impact on competition between asset managers

Adviser networks and vertical integration

5.39 Adviser networks may make funds available exclusively to financial advisers who are part of the adviser network. The adviser network may act as the fund manager itself, or may act as the Authorised Corporate Director and select third party asset managers to manage the fund as part of a 'fund of funds' arrangement.

5.40 Adviser networks have a commercial interest in promoting their own funds, as the network generates revenue from the investors that choose the in-house fund or portfolio. While we have not found any examples of adviser networks mandating the use of in-house funds, we have been told that the flow of money into in-house funds is growing. For example, one adviser network we spoke to has generated £1 billion AUM over the last 10 months in in-house funds.

5.41 The provision of in-house asset management services by advisers is a relatively new market development. Nevertheless, the development raises the following potential issues:

179 See FCA definitions here: www.fca.org.uk/firms/independent-and-restricted-advice

- How rigorous adviser networks are in selecting the fund managers that manage in-house fund of funds
- Whether the additional fee in a fund of fund arrangement represents value for money
- How the use of restricted investment solutions affects advisers' advice. For example, an adviser that is part of a network could be more inclined to pick a fund by relying on the network's due diligence

Model portfolios

5.42 Many consumers are looking for integrated solutions such as a fund of funds or model portfolio.[180] Model portfolios are a selection of investments designed to meet different risk profiles and investment objectives. The portfolios are pre-constructed and typically reviewed periodically.[181]

5.43 Financial advisers are increasingly offering model portfolios. NMG estimates that approximately 31% of investments below £50K are into model portfolios.[182]

5.44 A model portfolio is designed to help save advisers' time and resources in choosing the underlying funds and asset managers for each individual client. Model portfolios can be manufactured by adviser networks, third party firms or by advisers directly. The model portfolio designed will first choose the asset allocation that meets the retail investors' risk tolerance level or investment objective (such as growth or income) and then the fund or set of funds. The adviser is then free to assess their client's investment objectives or attitudes to risk, and to select a portfolio that offers that level of risk and meets the investment objective, without having to research each fund or investment separately.

5.45 The increasing use of model portfolios can potentially increase efficiency and give investors an investment proposition which is suitable to their needs. However, the use of model portfolios creates a number of risks. These are:

- **Comparability:** The huge selection and variability of types of model portfolios makes it difficult for investors and advisers to compare them. One adviser firm pointed out that, while model portfolios can benefit consumers, it is difficult to compare and analyse performance of different types of model portfolios.
- **Choice of asset managers:** The growth of model portfolios could make it difficult for asset managers to access routes to market if the designers of the model portfolio only choose between a limited range of fund managers or include their own asset management as part of the portfolio. For example, one firm said they choose from a selection of eight asset managers to build their range of model portfolios.
- **Value for money:** Investors will pay advisory fees, model portfolio fees, underlying fund fees and potentially a platform fee, with each having an impact on returns.

Third party ratings providers

5.46 There are a range of third party research firms that rate asset managers and funds. Designers of model portfolios, financial advisers and wealth managers can use these ratings to help shape their choice of asset manager and advice to retail investors. We were told that financial advisers

180 This conclusion was supported our consumer research which found that 50% of respondents chose a ready-made portfolio.

181 See FSA 12/15 *Assessing suitability: replacement business and centralised investment propositions* www.fca.org.uk/publication/finalised-guidance/fg12-16.pdf

182 NMG, *Financial Adviser Census*, July 2016

may restrict their fund research to funds which have a rating or risk profile from one of the number of rating providers.

5.47 Some industry commentators and stakeholders have raised concerns about third party rating providers' business models.[183] They suggest that some rating providers do not offer a whole of market review and some rating providers have to manage a conflict of interest where an asset manager agrees to pay the rating firm for a licence. We have also heard from asset managers who do not pay for a licence fees that they will then not be rated. We have not conducted any analysis of how widespread these business models features are, or how greatly they affect fund ratings and financial adviser recommendations. Nevertheless, we would be interested in stakeholder views about whether this is a market trend that we should further explore.

Do fund governance bodies consider value for money on behalf of investors?

5.48 Asset managers may be incentivised to control the costs and quality of ancillary services and core asset management services if there is strong internal governance which is required to scrutinise value for money.

Our work suggests fund governance bodies do not robustly consider value for money

5.49 While fund governance bodies exist, our supervision work suggests they do not robustly consider value for money. The Authorised Fund Manager (AFM) of an authorised fund has responsibilities to ensure that the fund it acts for meets its regulatory and legal responsibilities. The AFM is typically a subsidiary company within the company group structure that sponsors the fund range. Its board members are usually employed by and have operational roles within the group, and are frequently junior to the members of the group company board and its executive committee. We have seen only a few examples of independent non-executive members on such AFM Boards. Our expectation is that the board members of the AFM are those responsible for ensuring the robust governance of authorised funds and therefore the majority of our work has focused on that AFM board and its members.

5.50 Our supervision work indicates that these AFM boards generally do not robustly consider value for money for fund investors. For example, they often do not compare the asset manager's fees for managing a retail fund's portfolio with the fees they charge comparable institutional client accounts to assess whether the difference in fees is reasonable compared to the differences in costs. They do not typically question whether the economies of scale achieved when funds grow to reach certain levels of assets are shared with the fund investors in the way that break points are routinely used in institutional and segregated mandates.

5.51 We have found that AFM boards often fail to take appropriate and timely steps to address underperformance. They can also lack the authority within the group structure to challenge the commercial strategy set by more senior boards and executive committees. We found that where AFMs are part of the asset management group's corporate structure, with few or no independent directors, their directors face a significant conflict between their duties to the asset management group and their duties to the funds and their investors. In practice, we have observed that this conflict tends to be resolved in favour of the asset management group.

5.52 Instead of the typical AFM model described above, the asset management group sponsoring a fund range can approach a third party 'host Authorised Corporate Director ' firm to perform

183 See for example, www.fundstrategy.co.uk/is-the-market-skewed-by-conflicts-of-interests-on-fund-ratings/

the regulatory and legal responsibilities of the AFM.[184] Under this arrangement, AFM board members are unlikely to be employed by the asset management group and so might be expected to act with greater independence. However, the asset management group is clearly the client of the host Authorised Corporate Director firm, with the asset management group deciding on the selection and ongoing appointment of the host Authorised Corporate Director firm. This creates a similar conflict to that in the more typical in-house Authorised Corporate Director model and our supervision work indicates that host Authorised Corporate Director s are no more likely to assess value for money robustly than conventional AFM arrangements.

5.53 One example of robust consideration of fund charges was the AFM to a passive index tracker where the firm did not undertake its own distribution of its funds. The AFM had proactively considered a number of different fees/charges (including most importantly the AMC) that impact the investor's final share price and had taken steps to reduce them, simplify them and make them more transparent. These exercises were driven by the AFM board whose responsibility it is to act independently and solely in the interest of investors.

5.54 There are inherent conflicts of interest limiting the ability of AFM Boards and host Authorised Corporate Director Boards to act independently and in the best interest of the fund's investors as prescribed in COLL 6.6A.2R(6). Our supervision work has focused on AFMs' oversight of UCITS, but we believe that similar governance problems are likely to exist in management companies which are responsible for NURS and AIFs marketed to retail customers, as they face similar conflicts of interest.

Other areas considered

5.55 As part of the study, we looked at whether there were certain products and services that were only provided by a limited number of providers and whether this resulted in poor outcomes for investors. In particular, we considered competition for Liability Driven Investment (LDI) solutions. We found that those institutional investors that used LDI solutions were generally happy with both the product and the price. Even though concentration of the three largest providers remains high, the stakeholders did not flag any concerns about concentration or the ability to switch in this sector. We found that firms had entered the market to offer LDI services and were winning mandates, particularly pooled LDI solutions for smaller clients. We understand that existing asset management firms could enter and provide LDI solutions at a low cost if they wished to. We therefore do not propose any further work here, although we are open to views.

5.56 We also considered the role of institutional platforms. Platforms play an increasingly significant role in the DC sector. Institutional clients felt able to switch platform provider, and did not find difficulties in getting the funds they want on their chosen platform. Nevertheless, some providers raised concerns that getting a presence on an institutional platform was becoming more difficult, particularly when the platform was part of a vertically integrated group.

184 These firms are commonly called 'host Authorised Corporate Director s' rather than 'host AFMs', but act as the AFM or AIFM to the fund, and are commonly used by smaller or boutique asset management firms to enable them to access the market.

Questions for discussion and next steps

5.57 This chapter has considered the role that intermediaries and fund governance have on competition between asset managers. Overall, our preliminary work here shows that further work on platforms could be needed outside the scope of the market study.

5.58 We welcome views on whether FCA should carry out further analysis in the platform and adviser markets and if so in what areas. Examples could include, investigating the impact of vertical integration, model portfolios and third party ratings on competition in the sector and on value for money being achieved for end consumers.

6.
What do prices, performance and profitability tell us about how competition is working?

We looked at outcomes for investors and asset managers with reference to performance, price and profitability.

On performance, we find that:

- Institutional active investment products, on average, outperformed their benchmarks before charges were deducted. After charges there was no significant return over the benchmark for institutional products.
- Active funds for sale in the UK, on average, outperformed benchmarks before charges were deducted, but underperformed benchmarks after charges on an annualised basis by around 60bps.
- There is little evidence of persistence in outperformance in the academic literature, but there is some evidence of persistent underperformance. Our analysis provides some evidence of persistence of relatively poor performance. However, we have also found that asset managers are more likely to close or merge worse-performing funds. Further analysis is required to determine whether fund mergers result in better outcomes for investors.
- Some investors seek a target absolute return, rather than primarily seeking outperformance against a benchmark. However, in many cases the funds offering these styles provide misleading performance reporting to investors.
- Passive funds, after costs, would generally under perform against the relevant market benchmark. The market index is a theoretical construct which does not take into account the costs of investing. A cheap passive fund which closely tracks the index will have a low tracking difference and generate net returns close to the market benchmark. While passive funds are on average cheaper than active funds, around £6bn is invested in passive funds which are significantly more expensive than average.
- Some investors appear to be paying ‘active’ prices for products that are only partly active in nature. Since these products are similar to passive products, but just take small positions either side of the benchmark, many investors in expensive ‘partly active’ products would likely achieve greater value for money by switching to a cheaper passive fund in the same investment category.

On pricing, we find that:

- There is evidence of price clustering for active funds for sale in the UK. Prices paid by institutional investors in segregated mandates are subject to discounting and therefore there is less price clustering.
- Charges for active funds have remained stable over time. By contrast, charges for passive funds have been falling in recent years.
- There is little evidence that firms compete on the basis of price, in particular for active products. Responses from firms to our questionnaire suggest that charges are not a key competitive parameter for active products.
- Some investors may choose to invest in funds with higher charges in the expectation of achieving higher future returns. However, academic research from the US and recent Morningstar research suggests that higher charging funds are not on average generating higher performance, compared to cheaper funds in the same investment category. Our initial analysis indicates that, while there is no clear link between price and performance, on average the cheapest funds generated higher returns (both gross and net) than the most expensive funds.

On profitability, we find that:

- Average profit margins are around 35% for the period 2010 to 2015 and all the asset management firms in our analysis earn a return on capital employed above our estimate of the cost of capital. When adjusting profitability to reflect the fact that employees of asset management firms can be considered to be sharing in the profits of the firm through wages and bonuses, the estimated profitability of asset managers is even higher.

Introduction

6.1 This chapter looks at the outcomes both investors and asset managers achieve from the asset management industry. In doing this, we address the following questions:

- how are asset management firms and employees incentivised?
- what outcomes are achieved by investors seeking to beat the market?
- what outcomes are achieved by investors looking to manage returns and downside risk?
- what outcomes are achieved by investors that aim to achieve market returns?
- what do pricing patterns and the relationship between prices and net returns tell us about how competition is working?
- what does the profitability of asset management firms tell us about how competition is working?

6.2 A number of different pieces of evidence support the analysis and findings in this chapter. In particular:

- responses to a financial information request sent to 16 asset management firms setting out revenues and costs from 2010-2015.
- pricing data provided by 37 firms in our sample covering over 6,000 share classes.

- returns, net flows, AUM and charges data across over 20,000 share classes and 30,000 institutional investment products from third party databases.

How are asset management firms and employees incentivised?

6.3 In this section, we discuss whether the incentives of asset managers are aligned with those of the end investors. We consider this at the firm level, looking the prevailing fee model and the relationship between fund flows and performance mean for asset managers' incentives. We also consider it at an individual level, looking at the remuneration of asset management staff.

The prevailing fee model incentivises firms to grow assets under management, which is not necessarily aligned with investors' best interests

6.4 Asset managers typically charge a percentage of assets under management on an ongoing basis, referred to as the ad valorem pricing model. As explained in Annex 8, although firms' costs grow with an increase in assets under management, this is generally at a slower rate than the revenue growth. Asset management firms therefore typically benefit from economies of scale. As a result, in order to increase or maintain profitability, firms are incentivised to increase or retain assets under management.

6.5 Retail investors in particular base their investment decisions on past performance. So, to generate greater profits, firms need to demonstrate that they have performed well over the relevant period. However, there is a potential conflict between an asset manager's incentives to grow the size of their fund and the interests of the fund's investors due to the ad valorem fee structure.[185]

6.6 If the growth in assets under management reduces the ability of a fund's manager to generate higher returns, the manager's and investors' incentives may not be aligned. In this situation, fund managers may be willing to forego higher returns in exchange for earning larger fees by growing AUM.

6.7 Firms responding to our information request noted that when a fund gets too large, performance can suffer as there are decreasing returns to scale at a fund level. Those who responded to our information request suggested that this could be because larger funds are less agile and less able to respond quickly to pricing inefficiencies. It may also be because transactions on behalf of large funds are likely to have bigger market impacts. Consequently, if a particular fund manager is regarded as having superior ability, investors may put money into that manager's fund in the expectation of earning higher returns.[186] If there are decreasing returns to scale, then even if a manager of a large fund were seeking to maximise the performance of that fund we would expect its performance relative to its benchmark to worsen over time, unless that manager imposed capacity constraints.[187]

6.8 Therefore, the ad valorem fee structure could encourage fund managers to grow their assets under management beyond the level that the manager can continue to deliver excess returns to investors.

185 See the publication Clare, Motson, Payne, Thomas *Heads we win, tails you lose: Why don't more fund managers offer symmetric performance fees* (October 2014).

186 Rationally, assets would flow into a manager's fund up until the point at which expected abnormal returns to the investor in future are zero.

187 Some firms told us that funds and mandates are subject to capacity constraints. This is a limit on the size of the fund imposed by the asset management firm in order to stop the fund growing so big that it cannot meet its objectives. This limit differs depending on the strategy, less liquid asset classes typically having a lower capacity level than highly liquid asset classes.

6.9 A potential disciplining mechanism exists for these fund managers, whereby investors would switch their assets out of poorly performing funds and into better performing funds. However, if there is a convex relationship between fund flows and performance, so good performance is rewarded with inflows but bad performance does not lead to substantial outflows, then, combined with the ad valorem fee structure, asset managers would continue to have a strong incentive to focus on growing AUM.

6.10 Academic research, mainly from the US, suggests that, while better past performance leads to assets flowing into funds, weaker performance does not experience an equivalent net outflow of assets. We analysed the impact of Morningstar's star rating which measures past performance, with 1 star share classes representing the weakest historical performers and 5 stars representing the best historical performers. The 5-star rated share classes received large and positive net flows, while 1, 2 and 3-star rated share classes received relatively small negative net flows.[188] Therefore, we consider that there is likely to be an asymmetric relationship between net flows and performance in the UK.

6.11 This relationship between fund flows and performance may also lead to perverse incentives for asset management firms. First, firms could have an incentive to encourage their fund managers to focus their efforts and resources on their current winning fund(s) at the expense of other funds that are currently underperforming. Therefore, it could potentially result in poor performing funds experiencing persistent poor performance as poorer-performing funds are less well resourced.

6.12 Second, firms may rationally seek to change the risk profile of some of their funds over time in order to maximise assets under management. For example, reducing risk in better performing funds to capture any past performance and increasing risk in worse performing funds in the hope that the risk will pay off. This risk could differ from the expectations of the investors and could result in worse outcomes for the investor, for example where the increased risk doesn't pay off.

6.13 While performance fees for retail investors are not common, where they are used these are typically asymmetric. So the fund charges are greater when performance is above a certain level, but are not reduced for poor performance. One concern with this asymmetric pricing model is that it could lead to asset managers taking on more risk than they would otherwise do. This is because firms share some of the gains when big bets pay off, but do not share the losses when they do not pay off.

Individual asset managers are typically remunerated based on performance or contribution to firm profits

6.14 Based on responses received, we understand that fund managers are typically assessed on performance relative to peers or benchmarks over various time periods, and how closely they comply with mandates and risk budgets. However, the connection between defined performance criteria and pay is not symmetrically applied.[189] Discretionary bonuses are widespread, and penalties for underperformance or requirements to co-invest in funds are rare.

6.15 For several firms in our sample, it was unclear over what time period the performance was being measured. One firm looked at performance over a 1 year period and four firms looked at

188 We recognise that this only represents a statistical association, and so should not be interpreted as causation. However, we have found that after controlling for other potential drivers of net flows that the star rating has a positive relationship with net flows (in Annex 4).

189 Although we note that bonuses for the firms in our sample are on average around 40% of total remuneration, this has remained largely constant over the period of our sample.

performance between a 1-3 year period. Around 30% of firms looked over longer and multiple time periods.

6.16 Overall, we consider that longer time periods, and certainly more than a year are more aligned with investors' interests than shorter time periods, as asset management products are generally seen as medium to long term investments.

6.17 Only one firm had a clawback mechanism to penalise underperformance of its active managers, and did so in an asymmetric way, punishing underperformance more than rewarding outperformance. This was designed to prevent excessive risk taking. Another firm looked at performance alongside the Information Ratio[190] to assess whether the manager had added value.

6.18 In their bonus calculations, almost half of the firms in our sample rewarded fund managers for their contribution to the success of the company. Where firms defined this, it was either in the form of contribution to revenues or to profits. Rewarding managers for the company's success, as measured by revenues or profits, based on assets gained, is not necessarily aligned with the incentives of investors. As discussed above, incentives to increase the assets under management may result in worse outcomes for existing investors.

6.19 Only one firm in our sample made an explicit distinction between how retail and institutional fund managers were rewarded. Institutional fund managers' performance was measured gross of fees, and retail fund managers' measured net.

6.20 17 firms said risk management or complying with mandates are factors which influence performance assessment. Five explicitly used the number of compliance breaches as a negative factor. At two firms, risk management was explicitly related to performance, with the amount of risk taken to deliver the performance taken into account.

6.21 Firms also made reference to generating ideas, culture, behaviours and client service in their remuneration and appraisal assessments. However, this was typically as part of an overall assessment, which included other things such as fund performance.

What outcomes are achieved by investors seeking to beat the benchmark?

6.22 The majority of asset management products available for sale to UK investors seek to outperform a particular benchmark or index, with 68% of fund assets under management in the UK representing single asset classes of either equity or fixed income funds.[191] We looked at:

- whether asset managers outperform the market benchmark
- how outcomes differ based on the level of active management
- whether there is persistent outperformance
- whether there is persistent underperformance

190 A method of assessing how much excess return is generated from excess risk taken on. It is calculated as the ratio of alpha to the standard deviation of diversifiable risk.

191 Investment Association *Asset management survey* (2015). We are using this as a proxy for funds which seek to outperform benchmarks, although not all of these funds will be specifically seeking to outperform a given benchmark.

On average, asset managers do not appear to beat the market benchmark after costs

6.23 We find that, on average:

- active funds underperformed their benchmarks after charges;[192] and
- for institutional products, outperformance after charges was not significantly different from zero[193].

6.24 We considered share classes in the Morningstar dataset which had existed for all, or any part, of the period 2003-15. We calculated monthly net excess returns for each share class, and found the average of these on both a simple average and a money-weighted basis. We undertook this calculation for (i) all equity, fixed income (FI), multi-asset and alternative share classes and (ii) just for equity share classes.

6.25 To control for the impact of the RDR, where the net return of share classes shown in Morningstar's database includes the distribution fee for bundled[194] but not for clean[195] share classes, we used the following breakdowns:

- share classes which were both clean and bundled (i.e. no adjustments made to the data in Morningstar Direct)
- only share classes which were bundled
- only share classes which were bundled before the RDR period (pre-2013)
- Bundled shareclasses for the whole period and all clean shareclasses from 2013 adjusted to include a representative core platform charge of 0.375 per cent.[196]

6.26 Figure 6.1, shows the results using these breakdowns. We find that both active and passive funds (defined as trackers in Morningstar) underperformed on a net basis relative to their benchmarks. The exception to this is when we consider equity share classes only and use a money-weighted average: in three specifications the excess net performance for active funds is positive.

6.27 However, comparing the performance of these active and passive funds may not be a like-for-like comparison. This is because passive funds are more likely to be concentrated in a smaller number of equity categories than active funds.

6.28 In addition, active funds are able to invest outside their benchmark; therefore excess returns against their benchmarks are not necessarily reflective of the risk taken on. We will undertake further work to verify this finding before our final report, using factor-based models to estimate risk-adjusted returns.

192 The Morningstar dataset which we are using includes all GBP denominated share classes in open-ended funds available for sale in the UK in the period 2003-15. The dataset includes all retail and institutional share classes. Our dataset excludes ETFs, life funds, pension funds and other institutional segregated mandates.

193 Institutional products in e-Vestment

194 Bundled share classes include distribution fees (such as adviser commission or platform commission) within the Annual Management Charge (AMC). We identified bundled shareclasses using data from Morningstar Direct, enriched with information we received from a sample of asset managers. These indicated the charging structure of the share classes in our sample.

195 Clean share classes do not include any form of distribution fee within the AMC. We identified clean shareclasses using data from Morningstar Direct, enriched with information we received from a sample of asset managers. These indicated the charging structure of the share classes in our sample.

196 Calculated from data received from 4 platforms based on a pot size of £50,000

Figure 6.1: Monthly net returns over the benchmark in Morningstar Direct (percentage points)

			Clean and Bundled (2003-2015)	Bundled share classes (2003-2015)	Bundled share classes pre-RDR (2003–2012)	Bundled share classes, and clean share classes post-RDR with representative platform charge (2003-2015)
Equity, FI, Allocation, Alternative	Active	Simple Average	-0.08	-0.09	-0.08	-0.09
		Weighted Average	-0.04	-0.07	-0.07	-0.05
	Passive	Simple Average	-0.08	-0.08	-0.08	-0.10
		Weighted Average	-0.05	-0.06	-0.06	-0.07
Equity	Active	Simple Average	-0.01	-0.02	-0.02	-0.01
		Weighted Average	0.04	0.01	-0.02	0.03
	Passive	Simple Average	-0.07	-0.08	-0.07	-0.09
		Weighted Average	-0.05	-0.06	-0.06	-0.06

Source: Monthly net returns and benchmark returns data from Morningstar Direct, for open-ended funds with GDP denominated share classes available for sale in the UK.

6.29 We then looked at institutional investment products in the eVestment dataset which had existed for all, or any part, of the period 2003-15. We found that on average, after charges, the performance of these products in comparison to their benchmarks was not statistically different from zero[197].

6.30 Taken together, this indicates that both retail and institutional investors in funds and mandates, on average, outperformed their benchmarks before charges. We consider that this requires further investigation. If this result reflects genuine outperformance then other investors must collectively have underperformed benchmarks. This is because across all active investors performance before charges is a zero sum game relative to the benchmark.

6.31 On average, market participants who include not just fund investors but also non-fund investors such as individual stock pickers in a given market[198] cannot expect to beat the market benchmark before costs. This is because the market is defined as being made up of all of the trades undertaken by all market participants, and the benchmark is composed of all the securities within that given market.

6.32 As shown in Figure 6.2, we would expect that active money invested in the stocks of a particular market would have a distribution of gross returns approximately represented by the bell curve on the right (dashed lines), with the average point approximately being the market benchmark.[199] On a money-weighted basis, we would expect around half of the active money in the market to achieve returns at or above this average and around half at or below it. Since

197 We calculated quarterly net excess returns for each product, and calculated a simple average

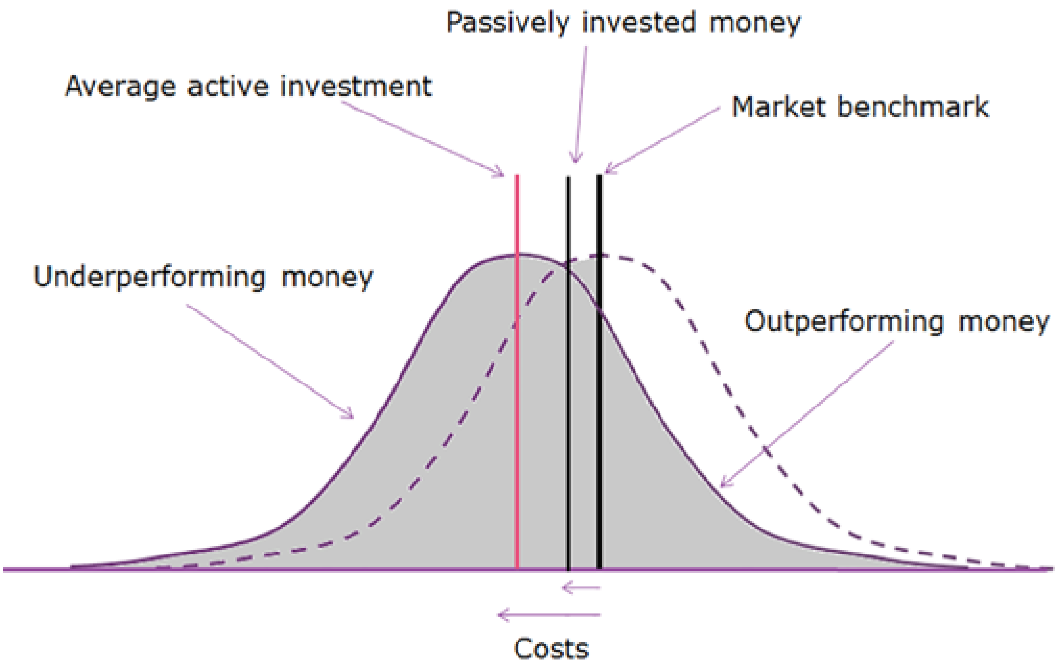
198 This holds true for investors that are only investing in the securities within that market. Where investors, such as fund managers are investing in securities which are outside their chosen benchmark, on average, they may achieve higher or lower returns than the benchmark but, in this case, the benchmark would not truly represent the risk taken on.

199 A given market would have market participants other than fund managers invested in it, including retail investors directly investing in stocks, banks, high frequency traders, pension funds managing their own money, other corporates and (private / family) business owners.

passive investments should approximately earn the market return gross of fees, we would expect active and passive investment styles, on average, to earn the same market return on a gross basis, but we would expect a wider distribution for active funds (ie more winners and losers) in any one year.

6.33 In reality both active and passive investment styles involve some trading activity.[200] In addition, investors in funds or mandates pay charges to asset managers for managing their money. After charges are taken into account different outcomes can occur. Any charges from agents, such as asset managers, reduce the return to underlying investors.[201] We have depicted a potential market outcome after fees in the left hand bell curve (solid lines) in Figure 6.2. As long as average active charges and transaction costs exceed the charges and transaction costs of tracking the market benchmark[202] (investing passively), more active money would underperform the market benchmark (and passively-invested money) after charges than outperform it.[203] In Figure 6.2, the non-shaded area shows the actively managed money that would outperform the benchmark.

Figure 6.2: a theoretical distribution of returns in a market, before and after fees



6.34 We have found that on average, retail investors in both active funds and passive funds underperformed their benchmarks net of costs.[204] Further, we have found that on average (on both a frequency and money-weighted basis) active and passive funds achieved similar net returns over the 2003-2015 period as shown in Figure 6.1. However, as discussed in paragraph 6.27, this may not be a like-for-like comparison.

200 Assuming that the market portfolio changes over time, passive asset managers would be required to update their holdings in order to track the market.

201 When market participants trade with each other, there is a winner and a loser, but there is also a third component. There are market participants who facilitate transactions and extract transaction costs, and so the return for the underlying investors in the market is the return on the market, less the agency cost of the asset managers, less the costs of transactions.

202 The market benchmark will be the weighted average of the gross returns on the stocks within that market.

203 This assumption is consistent with our findings on both the OCF and transaction costs

204 Analysis based on examining funds in the following asset classes: equities, fixed income, allocation and alternative.

6.35 In order for an asset manager to perform better than a passive product in the same investment category, the active asset manager would need to exceed the benchmark by the additional amount charged for the active product.[205] Based on historical data, on average, this means that the active asset manager would need to achieve a return more than 12.5% greater than the market (or an additional 81 basis points per year) in order to outperform against a comparable passive manager.[206]

6.36 Investor outcomes can also differ depending on the type of 'active' fund that they are invested in when trying to outperform against a benchmark. For example, some active funds take positions that are significantly different to the benchmark either for a long term investment, so-called 'buy and hold' investors, or as part of a high turnover short term investment style that seeks to make a series of short-term gains. These funds may generate returns that differ substantially from the benchmark, and so could generate returns closer to the extreme sides of the above chart with under- or out-performance.

Expensive 'partly active' funds are unlikely to deliver value for money

6.37 Alternatively, certain asset managers supply active funds that deliver returns similar to a market benchmark over a sustained period of time. These funds may be explicitly constrained by a benchmark or they may be managed in a way which seeks to stay relatively close to the benchmark, and therefore limit any potential underperformance. The returns to investors from these funds would be similar to the benchmark return before costs. We refer to such products as 'partly active' products.

6.38 Partly active products in general may be suitable for investors who wish to achieve returns similar to the market, but if they are priced at 'active' levels these products are unlikely to generate value for money for investors. This could occur if:

- some investors do not focus on charges (see Chapter 4);
- those investors that do examine charges compare partly active fees with active fees;
- fund objectives are opaque, meaning that investors are unable to differentiate between active funds and partly active funds (see Chapter 4). This could result in some investors that seek 'active' returns inadvertently placing their assets into a partly active fund priced at the same level; and
- investors in partly active funds are not aware that they could replicate a similar investment portfolio and risk level with lower charges by using some of their assets to purchase a cheap passive fund with a low tracking error, and use their remaining assets to purchase a fund with more active properties.

6.39 Figure 6.3 shows the distribution of net excess returns[207] against tracking error for all bundled active equity share classes (in the left hand graph) which existed for at least 12 months in the period 2003-15. In general, the lower the tracking error, the less it can be considered to be 'active'. This is because funds with low tracking error have returns that move closely with the returns of the benchmark. While a genuinely 'active' fund could display a similar tracking error to a passive fund over a shorter time horizon, we consider this possibility reduces as the assessment period increases.

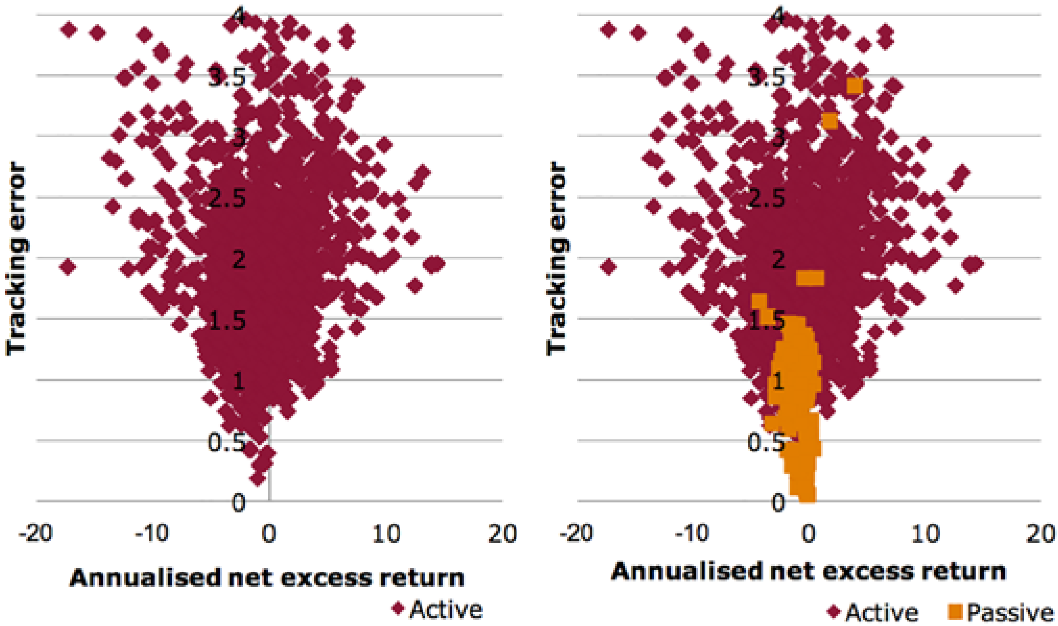
205 In addition, costs of transactions would also need to be reflected in this arithmetic (see earlier discussion).

206 Based on the average OCF for active and passive and explicit dealing costs using a market return of 6.34% (FTSE all share inc. div return 1996-2015)

207 We calculated the net excess return by computing the excess net return of each share class in each month and then taking the simple average of this. We annualised this by multiplying this figure by 12.

6.40 The right hand graph in Figure 6.3 shows passive funds overlaid onto the active distribution. This shows there are a large number of active funds which have a similar tracking error to passive funds. However, many of these funds are considerably more expensive and hence have lower net excess returns than comparable passive funds.

Figure 6.3: Distribution of excess net returns against tracking error – active share classes and active and passive

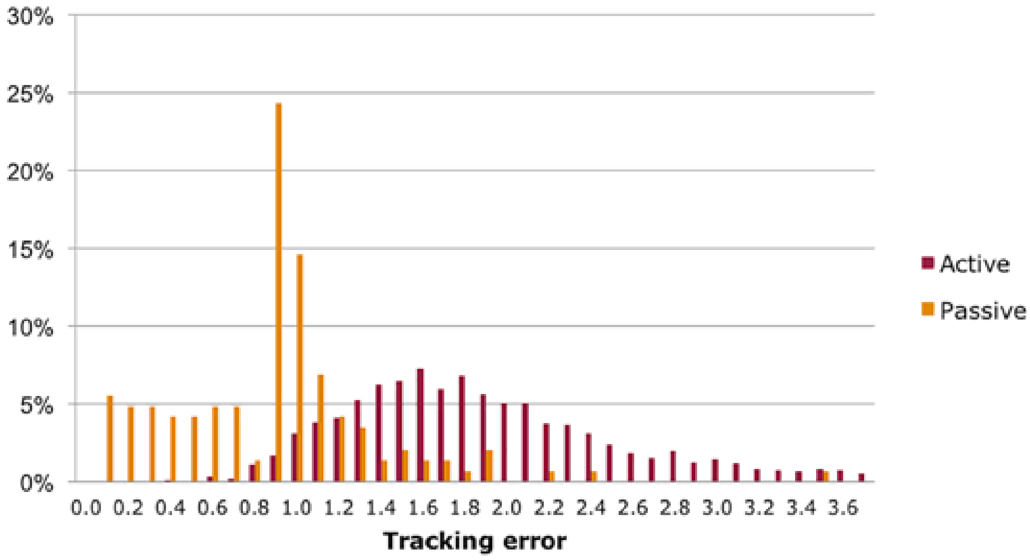


Source: Returns and benchmark data provided by Morningstar Direct.

6.41 Figure 6.4 shows the distribution of tracking error[208] for all equity funds which existed for at least 12 months over the period 2003-2015. Our analysis shows that passive funds generally have a lower tracking error than active funds. However, there are a number of active funds that have low tracking errors, where similar passive funds are available. We consider these to be 'partly active' funds as they are likely to share similar characteristics to passive funds, although retain an active element.

208 We have defined tracking error as being the standard deviation of the differences between monthly gross returns and the Morningstar Category Benchmark returns using the formula √(∑(return-benchmark return)^(2)/ (number of periods-1)

Figure 6.4: The distribution of tracking error for equity funds

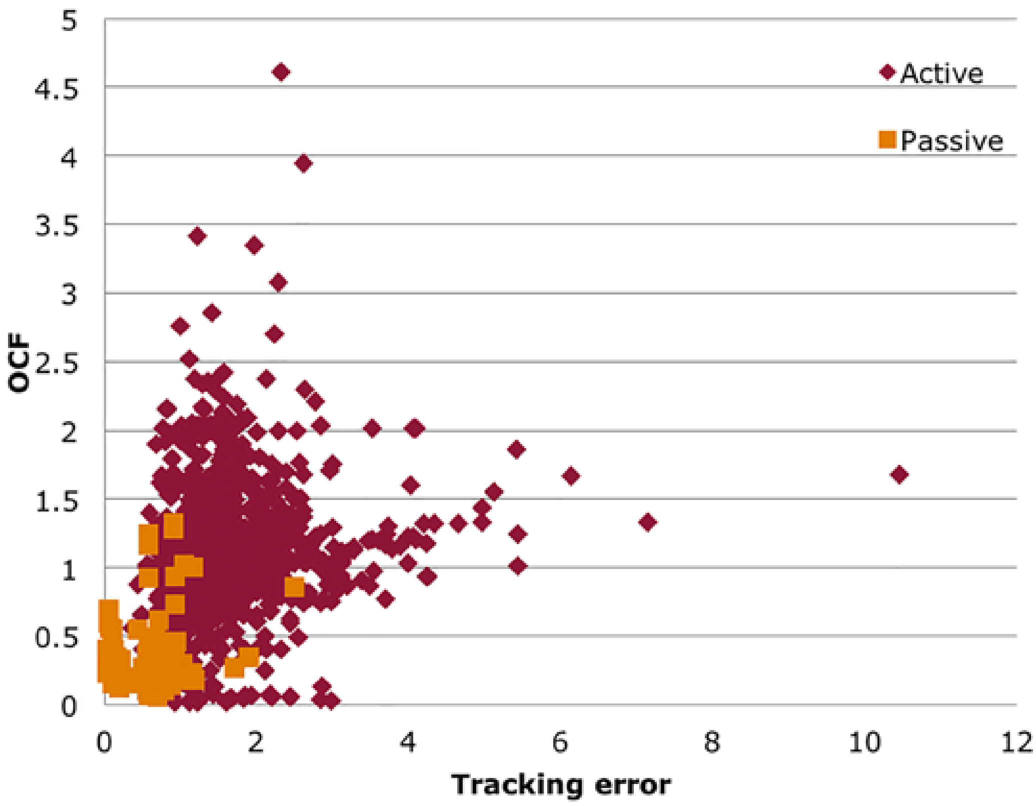


Source: Returns and benchmark data provided by Morningstar Direct.

6.42 We looked at how the OCF[209] for these partly active funds compares to the OCF for passive funds with a comparable tracking error. We compared tracking error with the OCF for clean equity share classes which existed during the whole of the period 2013-15 (i.e. after the RDR). Figure 6.5 shows that there are a significant number of partly active share classes with substantially higher charges than equivalent passive products. Investors in these relatively expensive partly active products would likely achieve better value for money from switching to a cheap passive fund in the same investment category.

209 The Ongoing Charges Figure

Figure 6.5: Tracking error against OCF for clean equity share classes over 2013-15



Source: Returns and benchmark data provided by Morningstar Direct. OCF data from a sample of asset managers, enriched with information on charges from Morningstar Direct.

6.43 Given the potential poor value for money for investors in such products, we have examined the amount of AUM in equity share classes with different levels of tracking error.[210] We have analysed the cumulative AUM which is in active share classes for different levels of tracking error, as well as the cumulative proportion of active and passive share classes for different levels of tracking error.

6.44 Based on Figure 6.5, we believe that partly active equity share classes could be defined as having a tracking error of up to 1.5. We have performed two sensitivities, in which we define partly active products as those with (i) a tracking error of 1.1 or less and (ii) a tracking error of 1.5 or less. This is shown in Figure 6.6. We consider that the active AUM figures represent an upper bound on the amount of AUM in partly active funds as some of these shareclasses may be charged lower prices to reflect the hybrid nature of the product. We have therefore estimated which funds have an OCF (or AMC where this was not available) of equal to or greater than 0.5% for clean share classes, and 1.0% for bundled shareclasses. We provisionally conclude that around £109bn is in expensive partly active funds.

210 We have examined equity funds which existed for at least 12 months over the period 2003-15 and which still existed in December 2015.

Figure 6.6 Assets under management with low tracking error

Tracking error	% of passive share classes[206]	% of active share classes[207]	Active AUM[208]	Active AUM – OCF or AMC charges at or above 1% bundled or 0.5% clean
1.5 or less	96%	42%	£142bn	£109bn
1.1 or less	83%	15%	£49bn	£35bn

6.45 Tracking error is only one methodology for estimating how active a fund is. Other methodologies include for example, looking at active share or the underlying holdings of funds. We welcome feedback from interested parties on the appropriate methodology for identifying high-priced partly active products that are unlikely to offer value for money to investors.

Outperformance is not likely to persist

6.46 Our evidence suggests that investors, particularly retail investors, appear to focus on past performance when choosing between funds. We explained in Chapter 4 that it is difficult for investors to identify outperforming funds. However, even if investors can find funds that have performed well in the past, this past performance is not likely to be a good indicator of future performance.

6.47 There is little evidence of persistence in outperformance in the academic literature. As summarised in Figure 6.7, previous UK academic analysis has found that the majority of funds with historical outperformance do not continue to outperform the relevant market index or peer group for more than a few years.[214] By contrast, where performance persistence has been identified in the literature, it is poor performance persistence (see table below).

211 By frequency. When calculated by AUM the results are 99% and 85% respectively.

212 By frequency and AUM

213 This figure represents GBP denominated share classes in equity funds available for sale in the UK.

214 For example, see the bi-annual scorecards that compare the performance of actively managed funds against their benchmarks (known as SPIVA), which are published by the S&P Dow Jones Indices.

Figure 6.7 Summary of the existing UK literature on performance persistence

Authors	Sample	Finding on performance persistence
Blake and Timmermann (1998)[209]	Almost complete sample of 814 UK open-ended mutual funds over the 1972 to 1995 time period (Micropal dataset). Returns calculated excluding transaction costs or management fees.	Find that the average UK equity fund underperformed by ca. 1.8% per annum (risk-adjusted). Some evidence of positive performance persistence among historically best-performing funds, but also a large average survival bias of 0.8% per year. Wide dispersion in performance between international and domestic funds
Quigley and Sinquefield (2000)[210]	Survivor-bias-free UK equity data (Micropal dataset) of all open-ended mutual funds (unit trusts) over the 1978 and 1997 time period. Limited to UK (Growth and Income, Growth, Equity Income or Smaller Companies) funds invested to at least 80% in UK equities	Find some limited persistence in overperformance but to achieve the result would require an 80% turnover per year which in practice would increase the transaction costs to the point of wiping out any profits. Underperformers persist longer: "Losers repeat, winners do not."
Fletcher and Forbes (2002)[211]	Sample of 724 unit trusts of which 139 (General, Income, and Growth) UK trusts with continuous returns for the 1982 to 1996 period. Data collected from the annual Unit Trust Yearbooks.	Find that persistence in performance of the mean monthly excess returns is a short-run phenomenon. However, if compared to an absolute benchmark, significant persistence in the relative rankings of unit trusts in annual excess returns turns into significant underperformance.
Cuthbertson et al. (2008)[212]	935 (699 surviving funds) UK open-ended equity mutual funds over the 1975 to 2002.	Find persistent outperformance of few top funds and persistent underperformance "amongst many poorly performing funds." Also find that ex post rankings of top performers are a poor guide for future performance which "makes it extremely difficult for the 'average investor' to pinpoint individual active funds which demonstrate genuine skill."

6.48 The insights from the literature can be seen by examining data on performance persistence for funds available to UK investors. Figure 6.8 shows that as the time horizon increases from one up to ten years, more and more GBP-denominated active equity funds (a proxy for active funds available to UK investors) underperform against their respective benchmarks. For example, whilst only 22 per cent of UK equity funds underperformed benchmarks in year 1 (2005)[219], 72% of those funds had underperformed by year 10 (2015). It is important to recognise that

215 Blake, D., Timmermann, A. (1998). Mutual fund performance: Evidence from the UK. European Finance Review 2, 57-77.

216 Quigley, G., Sinquefield, R. (2000). Performance of UK equity unit trusts. Journal of Asset Management 1(1), 72-79.

217 Fletcher, J., Forbes, D. (2002). An exploration of the persistence of UK unit trust performance. Journal of Empirical Finance 9 (5), 475-493.

218 Cuthbertson, K., Nitzsche, D., O'Sullivan, N. (2008). UK mutual fund performance: Skill or luck? Journal of Empirical Finance 15 (4), 613-634.

219 The short-term underperformance figure varies materially, and the latest data to June 2016 shows that 86% of UK equity funds underperformed in year one. However, the 10 year data does not vary significantly, with 77.08% of funds underperforming in the updated dataset.

these figures potentially underestimate the extent of underperformance as they do not capture the funds that have closed or have been merged into other funds due to poor performance.

Figure 6.8: Percentage of GBP-denominated European equity funds that underperformed their benchmarks

Fund Category	Comparison Index	One-year (%)	Three-year (%)	Five-year (%)	Ten-year (%)
Europe Equity	S&P Europe 350	17.35	45.16	57.73	72.58
Europe Ex-U.K. Equity	S&P Europe Ex-U.K. BMI	24.79	55.46	59.84	72.66
U.K. Equity	S&P United Kingdom BMI	22.16	33.76	52.91	71.82
U.K. Large-/Mid-Cap Equity	S&P United Kingdom LargeMidCap	14.14	26.7	46.09	70.67
U.K. Small-Cap Equity	S&P United Kingdom SmallCap	49.25	64.29	78.08	81.16
Global Equity	S&P Global 1200	61.19	77.72	89.73	89.08
Emerging Markets Equity	S&P/IFCI	71.93	73.28	73.74	85.42
U.S. Equity	S&P 500	78.04	80.26	94.97	94.52

Source: S&P Dow Jones Indices, SPIVA European Scorecard. Data for periods ending 31 Dec 2015.

6.49 Non-persistence in fund outperformance is seen in the US, where there is generally an inverse relationship between length of time and the ability of top-performing funds to maintain their status. Of the 664 US equity funds that were in the top quartile of performers as of March 2012, only 0.30% remained in the top quartile in March 2016 (see Figure 6.9). Similarly, of the 1,328 US equity funds that were in the top half of performers in March 2012, only 6.02% remained in the top half at the end of March 2016.

Figure 6.9: Performance persistence of US equity funds over five consecutive 12 month periods

Mutual fund category	Fund count at start (March 2012)	Percentage remaining in top quartile			
		Mar 2013	Mar 2014	Mar 2015	Mar 2016
Top Quartile					
All Domestic Funds	664	11.9	2.26	0.75	0.3
Large-Cap Funds	257	15.56	1.95	0.78	0.78
Mid-Cap Funds	95	11.58	3.16	2.11	0
Small-Cap Funds	147	23.13	4.08	0.68	0
Multi-Cap Funds	165	19.39	4.85	3.03	1.21

Mutual fund category	Fund count at start (March 2012)	Percentage remaining in top half			
		Mar 2013	Mar 2014	Mar 2015	Mar 2016
Top half					
All Domestic Funds	1,328	43.67	18.22	10.39	6.02
Large-Cap Funds	513	37.04	13.65	8.38	3.7
Mid-Cap Funds	190	37.37	16.84	7.89	5.79
Small-Cap Funds	294	51.36	24.83	15.65	7.82
Multi-Cap Funds	331	39.27	17.52	10.27	5.74

Source: S&P Dow Jones Indices, The Persistence Scorecard. Data for periods ending 31 Mar 2016

6.50 The implication of the above evidence is that past good performance is empirically not a good predictor of future good performance for most funds and asset classes, and therefore is not a good indicator for investors looking for outperformance.

There is some evidence that poor performance exists, but poor-performing funds get merged or closed

6.51 We have performed our own analysis of the performance of funds over time to assess whether underperformance persists. Figure 6.10 below shows the quartiles of performance into which funds fell during the period 2005-2010, and compares this to their subsequent performance over 2011-2015. For this analysis we considered active equity funds and defined performance as the difference between their gross returns and the Morningstar Category Benchmark.

6.52 We find that 11.4% of funds which were in the bottom quartile of performance between 2005 and 2010 continued to be in the bottom quartile in the subsequent five years. We consider this is evidence of relative poor performance persistence. In addition, 35% of the funds that were in the bottom-performing quartile over 2005-2010 subsequently closed or merged over 2011-2015. To the extent that poor-performing funds are more likely to be closed or merged, Figure 6.11 will understate the degree of poor performance persistence.

Figure 6.10: Comparison of relative gross excess returns for equity funds between 2006-10 and 2010-15: proportion of funds

	2011-15				
2006-10	1st	2nd	3rd	4th	Closed or Merged
1st	24.4%	21.4%	18.8%	21.0%	14.4%
2nd	22.4%	18.4%	18.8%	16.2%	24.3%
3rd	14.0%	17.3%	19.1%	16.5%	33.1%
4th	18.8%	18.8%	16.5%	11.4%	34.6%

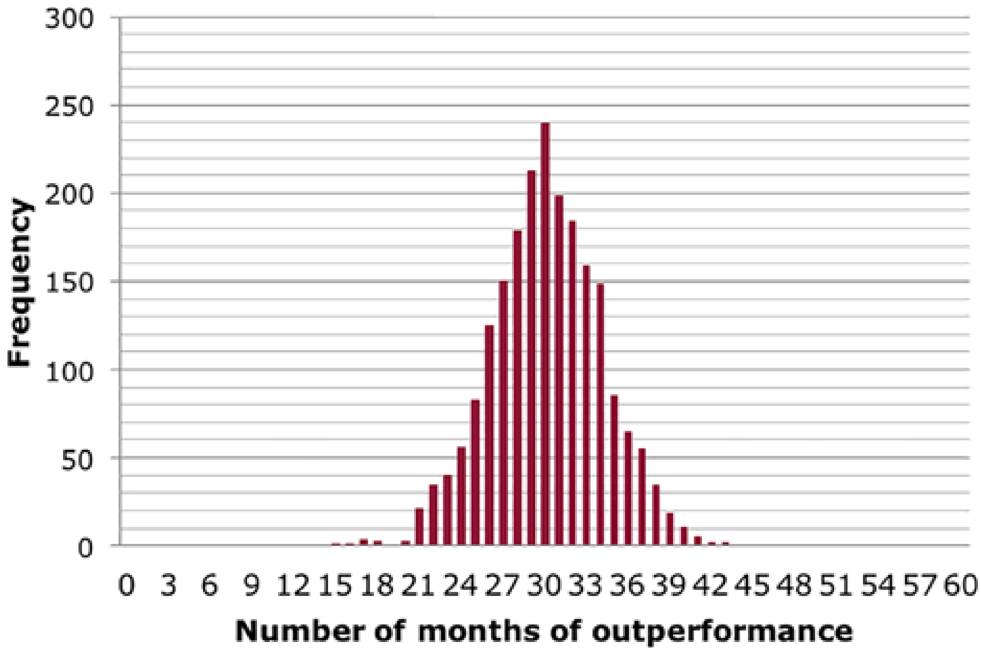
Source: Gross returns and benchmark data provided by Morningstar Direct.

6.53 Figure 6.11 shows the frequency with which retail share classes outperformed their benchmarks, after costs, over a 60 month period.[220] This shows that the distribution of months of outperformance is approximately symmetric about 30 months, and there is no clear tail of funds that have underperformed for the vast majority of this assessment period.[221]

220 In this analysis, we considered active equity share classes with a bundled charging structure which existed for the whole period 2008-2012. We chose this methodology as it meant that we were able to analyse net performance on a consistent basis which would have been challenging using the post-RDR data.

221 We found that there are not a large number of retail share classes which consistently underperform relative to their benchmarks. For example, we have found that only 7.7% of retail active equity share classes underperformed benchmarks for at least 36 months over a 60 month assessment period, or 5.4% on a money-weighted basis. Similarly, only 0.4% of retail active equity share classes underperformed benchmarks (on both a frequency and AUM basis) for at least 42 months over a 60 month assessment period.

Figure 6.11: The frequency with which retail share classes outperformed their benchmarks on a net basis in the period 2008-12



Source: Net returns and benchmark data provided by Morningstar Direct.

6.54 We have examined the distribution of over- and under-performance of share classes against benchmarks on a net basis according to their longevity. We examine the cohort of share classes which were launched at any point between 2005 and 2007 and find that share classes which only existed for part of the 2008-2012 period performed relatively worse than share classes that existed for the full 2008-2012 period. This analysis is consistent with the finding that worse performing funds are more likely to be closed or merged by asset management firms.

6.55 The academic literature discussed above suggests that there is evidence of persistent poor performance. Our own analysis provides some evidence of persistence of relatively poor performance, but that there is also some self-correction occurring in the marketplace, whereby asset managers are more likely to close or merge worse performing funds. Further analysis is required to see what effect fund mergers and closures have on outcomes for investors. This would include looking at whether fund mergers result in better post-merger performance, or whether these merged funds continue to perform poorly once they have been merged.

What outcomes are achieved by investors that aim to achieve market returns?

6.56 Some investors seek to invest in a given market, in the expectation that they will receive a return similar to the market benchmark. Around 23% of assets managed in the UK are managed on a passive basis.[222]

222 IA data, representing index tracker funds. This does not include smart beta funds.

6.57 Passive funds, after costs, would generally under-perform against the relevant market benchmark. The market index is a theoretical construct which does not take into account the costs of investing. A cheap passive fund which closely tracks the index will have a low tracking difference and generate net returns close to the market benchmark.[223] Tracking difference represents the difference between the market return and the return of the passive fund and can exist because of factors such as:

- the ongoing charges for the passive fund, including the annual management charge and ancillary service charges (our estimates suggest this is around 0.11% on average),
- trading costs which are not disclosed in the ongoing charges figure,
- differences between the composition of the market benchmark and the index at any given time, where the fund does not perfectly replicate the benchmark,
- securities lending revenues: where a fund lends out stocks and receives money for this,
- other factors such as taxation and FX rates.

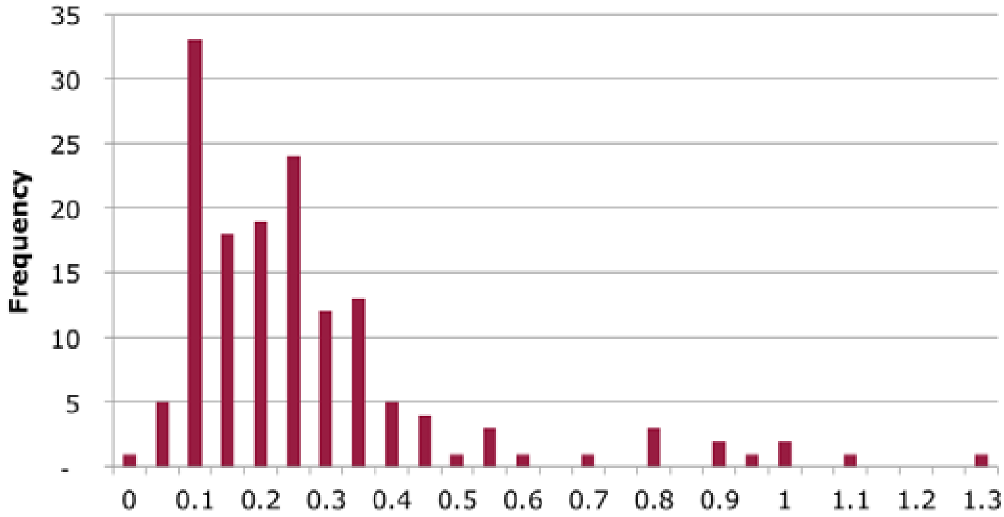
6.58 As a result, the lower the tracking difference, the closer to the market benchmark the passive fund will be. However, we have found that there is a substantial amount of AUM invested in passive funds that are priced highly and therefore are unlikely to be delivering value for money. This could be explained by investors not focusing on the charges of funds when selecting or reviewing their investments. We have found that around £6bn is invested in passive equity funds with an OCF equal to or above 0.5% for clean share classes or equal to or above 1.0% for bundled share classes.[224] We consider that investors in these products are likely to benefit from switching to better quality, lower priced passive funds in the same investment category.

6.59 As shown in Figure 6.12 and Figure 6.13, for both clean and bundled share classes, we find that there is a small proportion of index-tracking share classes which charge substantially more than others. A large proportion of the expensive passive funds had inception dates between 1982-2010.

223 This assumes that the costs of transactions faced by passive funds are not substantial.

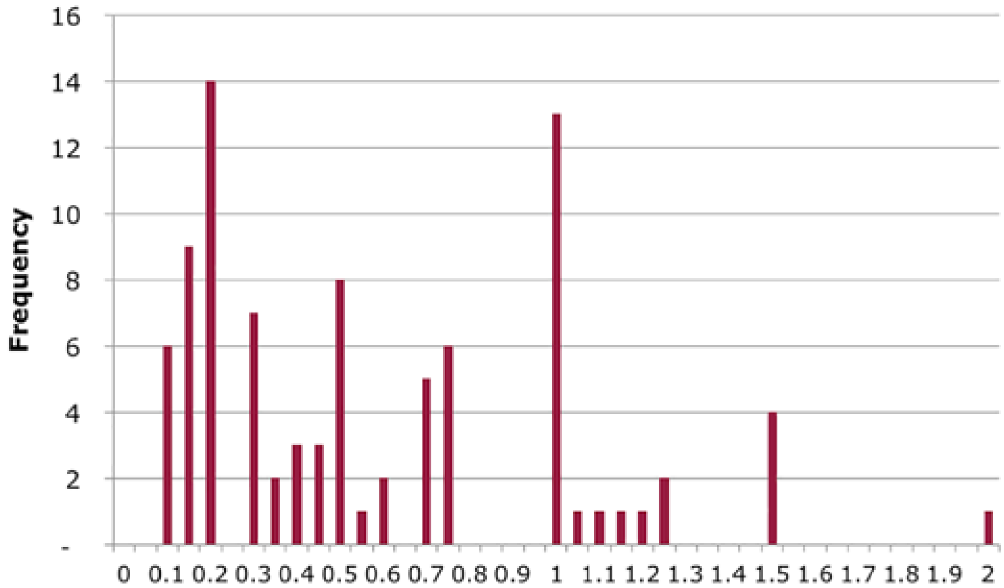
224 As of December 2015. We used the fund's AMC when the OCF was not available.

Figure 6.12: The distribution of OCF for clean index-tracking equity share classes



Source: OCF data from a sample of asset managers enriched with information from Morningstar Direct.

Figure 6.13: The distribution of OCF for bundled index-tracking equity share classes



Source: OCF data from a sample of asset managers enriched with information from Morningstar Direct. AUM data from Morningstar direct

What outcomes are achieved by investors seeking to manage returns and downside risk?

6.60 Not all investors are seeking to outperform a given market. Some are looking for active asset management to manage the downside risk of their investment. For example, they may be prepared to accept market returns or even below market returns when markets are rising, in the hope that when markets fall, their fund manager is able to limit the downside risk. This could be, for example, by moving investments out of a falling market.

6.61 Investors are also increasingly seeking absolute returns, rather than returns relative to a benchmark. Funds which meet this demand typically seek to generate returns using a range of asset classes and derivative instruments to manage risk.

6.62 We have considered what the market trends and outcomes look like for investors who want to take on a level of risk which differs from the market or manage their downside risk and/or get an absolute return.

6.63 Targeted absolute return funds seek to provide investors with positive returns and these products can work well for investors looking to manage the volatility of their investments. However, we are concerned that many of the targeted absolute return funds are not sufficiently clear about how they have performed. In some cases we found the benchmarks for targeted absolute return funds are not representative of the risk taken on or are misleading, and the threshold for performance fees was lower than the return targeted.

6.64 According to the IA, as of September 2016 there were 107 funds in the IA's targeted Absolute Return Funds sector. In September 2016, of the 74 ARFs that had reported 24 months of rolling performance, 6 funds had reported negative performance for 20 or more months over the last 24 month rolling period. In addition, 27 funds in the sample reported negative rolling performance for 12 or more months. While the performance data of this sector over a 24 month rolling period may not be representative of its long-term performance, these numbers suggest that customers can face a high likelihood of negative performance. In addition, funds in this category can have high volatility, which means that the returns to investors in these absolute return funds may be more volatile than expected. 23 funds in the sector currently have an SRRI[225] of 5 or above (with the rating measure running from 1 – lowest volatility – to 7 – the highest volatility), which is calculated on 5 year fund returns, and suggests an annualised volatility in these funds is greater than 10%.[226]

What do pricing patterns and trends and the relationship between prices and net returns tell us about how competition is working?

6.65 To better understand the outcomes for different investor types, and to inform our understanding of how competition is working for asset management products, we have assessed how prices have changed over time for different groups of investors.

6.66 Pricing analysis can help us understand whether price competition exists, although not in isolation. For a more complete picture, we also need to consider what is happening to underlying costs. Therefore, this analysis should be considered alongside the analysis on profitability which is set out from paragraph 6.88.

Active prices have remained broadly stable and we see clustering of prices

6.67 We have analysed pricing trends for actively managed funds invested in by both retail and institutional investors. This includes partly active funds (discussed in the previous section). Our analysis, set out below, suggests that there is limited price competition between active fund managers.

225 The Synthetic Risk and Reward Indicator (SRRI) measures the volatility of the fund.

226 See data here: www.theinvestmentassociation.org/fund-sectors/targeted-absolute-return-tool.html

6.68 This analysis is supported by responses from firms to our information request. Very few asset management firms told us they lower charges to attract investments, particularly for retail investors – as they did not believe that this would win new business. Firms responding to our information request explained that fund charges are typically set at launch, and these charges are generally set at the same level as their competitors. Firms noted that at the launch of a fund the level of investment a fund will attract is uncertain. If a minimum or target AUM is not subsequently achieved by a fund then firms explained that they would likely respond by closing or liquidating the fund rather than reducing charges. Taken together, this suggests that charges are not regarded by firms as a key competitive parameter.

6.69 There appeared to be greater price competition for institutional investors who are frequently offered discounts. Most institutional asset managers offered discounts from the headline price to institutional investors. Discounts were generally offered based on:

- the size of the mandate, with larger mandates obtaining greater discounts.
- the strategic importance of the client, for example if clients have other investment products with the firm they are likely to get a discount.
- the product type, with firms offering discounts for investors into new and innovative products, particularly without a three year track record.

6.70 As shown in Figure 6.14, we have found that asset management charges (the OCF) for active funds have not changed significantly over time. This can be seen by examining the Bundled and Clean lines in the figure below. These two price series are not affected by product mix effects caused by the regulatory effects of RDR. The figure shows that the weighted average OCF for both of these series was roughly constant over the assessment period.

6.71 In this analysis, we calculated the AUM-weighted OCF for UK equity share classes which were available in each individual year according to whether they were active or tracked an index. In order to account for the impact of the RDR, whereby the OCF would not include the distribution fee for clean share classes, we produced two different price series:

- Considering only share classes which were bundled ("Bundled" line)
- Considering only share classes which were clean ("Clean" line)

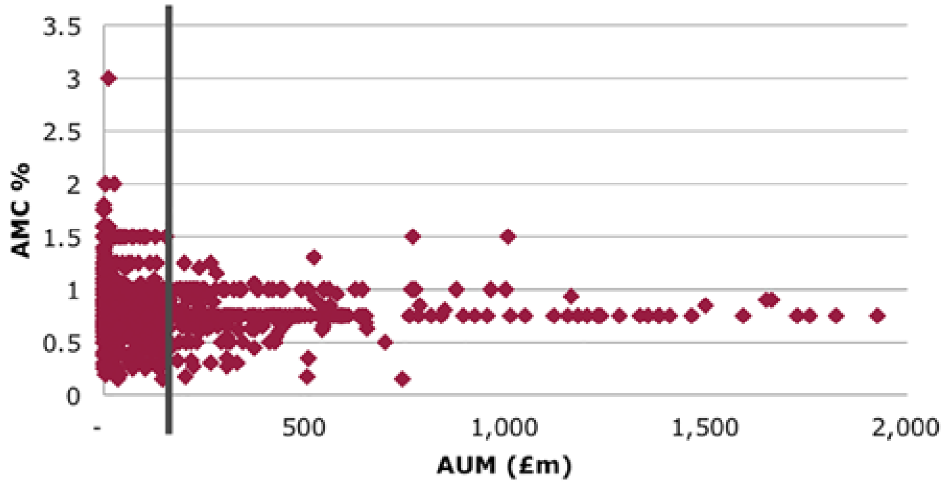
Figure 6.14: Trends in the AUM weighted OCF for active share classes over time

Source: OCF data and information about the fee structure of share classes from a sample of asset managers enriched with information from Morningstar direct. AUM data from Morningstar Direct.

6.72 In addition we find that clustering of prices appears to be a feature of the asset management industry. We find that clustering becomes more apparent when examining narrower investment categories. This matches responses from asset managers about how they set prices.

6.73 Figure 6.15 below shows that there are certain price points for the AMC. In this analysis we considered clean active equity share classes in December 2015. Whilst there is an element of price dispersion for share classes with a limited amount of AUM, as AUM increases the clustering becomes more pronounced (see data points to the right of the grey line). There appears to be clustering at 1% and at 0.75% across all equity classes, which is likely to reflect price points for different product types.

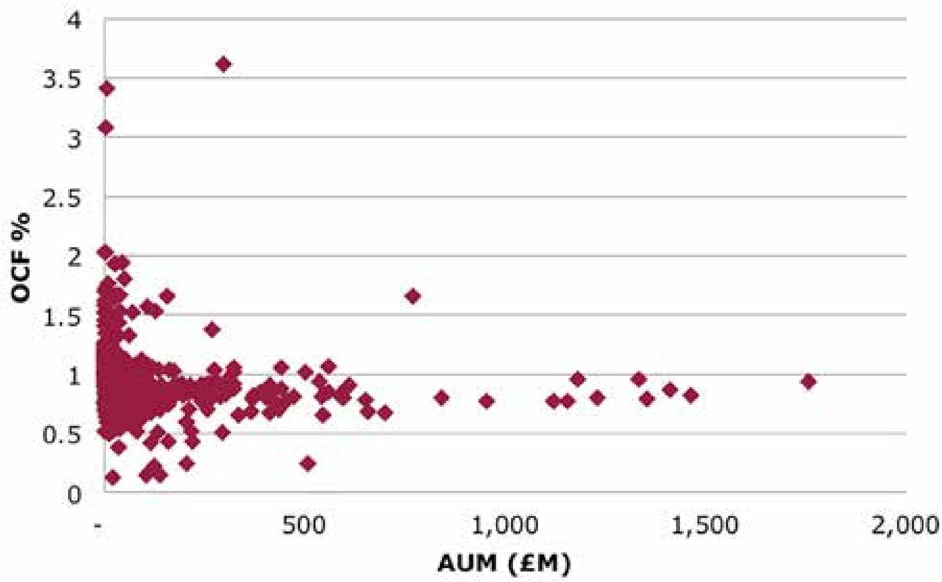
Figure 6.15: The distribution of AMC against AUM for equity share classes



Source: AMC data from a sample of asset managers enriched with information from Morningstar Direct. AUM data from Morningstar Direct.

6.74 Figure 6.16 also shows that there is not a large amount of variation in the OCF (see data points to the right of the grey line) across all equities, using clean share classes. We would expect more variation in the OCF as this depends on charges levied by third parties. As above, we have found that clustering becomes more pronounced the narrower the investment category.

Figure 6.16: The distribution of the OCF against AUM for equity share classes



Source: OCF data from a sample of asset managers enriched with information from Morningstar Direct. AUM data from Morningstar direct

6.75 In both Figures 6.15 and 6.16, once assets under management are greater than around £100m prices do not change significantly based on the number of assets under management.

This implies that any fund level economies of scale do not get passed on in lower charges to investors. We discuss firm level economies of scale in more detail in Annex 8.

6.76 Prices for institutional funds also exhibit clustering. However, institutional investors investing in segregated mandates individually negotiate their fees with asset managers which means that prices are more likely to be dispersed.

Passively managed funds have fallen in price over the last 6 years

6.77 Figure 6.17 shows that there has been a general downward trend in the price of index-tracking funds over, at least, the last decade, using the same methodology as in the previous section. However, as we highlighted in paragraph 6.58, there is still a small proportion of tracker funds which charge substantially more than others.

Figure 6.17: Trends in the AUM weighted OCF for index-tracking share classes over time

Source: OCF data and information about the fee structure of share classes from a sample of asset managers enriched with information from Morningstar direct. AUM data from Morningstar direct.

The most expensive funds do not appear to deliver higher returns

6.78 Investors in asset management products typically aim to maximise their risk-adjusted net return. In doing so, it may make sense to invest in funds with higher fees, as long as this translates into higher gross and higher net returns.

6.79 On a gross returns basis, if there is a positive relationship between price and performance this would suggest that price is an indicator of a manager's ability to generate higher returns than average before fees. On a net returns basis a positive relationship would indicate that investors in above average fee products are being more than compensated for these higher charges in the form of higher gross performance, which translates into better than average net returns.

6.80 Academic research from the US suggests that there is a negative relationship between price and gross performance. We have summarised some of the literature below:

- Bazo and Verdu[227] analysed a sample of US equity mutual funds, finding a negative relationship between fees and before fee risk adjusted performance. Before risk adjusted performance was calculated using four-factor Carhart's[228] model. Their analysis shows that funds with worse before fee risk adjusted performance charge higher fees.

- Bazo and Verdu in another paper[229] provide evidence that equity mutual funds with worse before-fee performance charge higher fees. The authors set out a model to explain this finding, arguing that competition between better-performing funds for sophisticated investors pushes fees down, with poor-performing funds targeting unsophisticated investors. They also explored the possibility of poor-performing funds having higher marketing and distribution costs which are passed on to investors

- Elton et al.[230] also estimated that funds with higher fees deliver significantly lower before-fee returns.

- Malkiel[231] also found a negative relationship between a fund's total expense ratio and its net performance.

6.81 Recent Morningstar research[232] also suggests that there is a negative relationship between price and gross performance. Morningstar found that for different asset classes, the cheapest funds perform better than the most expensive funds.[233]

6.82 The research summarised above suggests that higher charging funds are not on average generating higher performance, compared to cheaper funds in the same investment category.

6.83 Since the research above focuses on US funds, we have performed an initial simple analysis of open-ended funds available for sale in the UK. Our analysis indicates that while there is no clear overall relationship between price and performance, on average the cheapest funds generated higher gross returns, and higher net returns, than the most expensive funds.[234] This finding is consistent with previous research.

6.84 We have analysed the returns and fees of active primary share classes available for sale to investors in the UK over the 2005-2015 period. We have analysed performance on a gross and a net of fees basis, and compared performance against fee levels. Specifically, we first categorised primary share classes into fee quintiles; for each quintile we calculate the gross and net performance of the corresponding share classes. We have focused on those share classes which are managed according to the same benchmark: the FTSE All-Share, to ensure that we are comparing fees and performance of similar share classes. To ensure that our analysis was not distorted by the effects of the RDR we performed two pieces of analyses:

- An analysis of bundled share classes over the 2005-12 period (pre-RDR).

227 Bazo and Verdu (2009) *The relationship between price and performance in the mutual fund industry* Journal of Finance, 2009.
228 Carhart (1997) *On persistence in mutual fund performance*, Journal of finance, 1997.
229 Bazo and Verdu (2008) *When cheap is better: Fee determination in the market for equity mutual funds.* Journal of economic behaviour and organization
230 Elton et al. (1993) *Efficiency with costly information: a reinterpretation of evidence from managed portfolios*, Review of financial studies
231 Malkiel (1995) *Returns from investing in equity mutual funds from 1971 to 1991*, Journal of finance, 1995.
232 Morningstar, *How fund fees are the best predictor of returns (2016)* www.morningstar.co.uk/uk/news/149421/how-fund-fees-are-the-best-predictor-of-returns.aspx
233 Morningstar grouped funds into quintiles based on charges within each Morningstar Category peer group. The cheapest funds are therefore those funds in the lowest fee quintile, and the most expensive are those in the highest fee quintile.
234 Our analysis also grouped funds into quintiles based on charges within a given peer group. The cheapest funds are therefore those funds in the lowest fee quintile, and the most expensive are those in the highest fee quintile.

- An analysis of clean share classes over the 2013-15 period (post-RDR).

6.85 Figure 6.18 shows the median gross and net performance for each fee quintile and for each sensitivity. It shows that the cheapest fee quintile (Q1) consistently achieves a higher performance than the most expensive quintile (Q5). However, beyond this finding we do not observe a clear overall relationship between fees and returns.

Figure 6.18: Monthly net and gross returns split by fee quintile (Q1 the cheapest, Q5 the most expensive)

	Bundled 2005-12		Clean 2013-15	
	Gross	**Net**	**Gross**	**Net**
Q1	0.97	0.87	1.05	0.92
Q2	1.05	0.92	1.14	1.06
Q3	1.07	0.91	0.96	0.83
Q4	1.16	0.98	1.21	1.10
Q5	0.94	0.74	1.02	0.88

Source: FCA analysis of gross and net returns against fee quintiles.

6.86 We will investigate this area further after this interim report and welcome feedback from interested parties.

What does the profitability of asset management firms tell us about how competition is working?

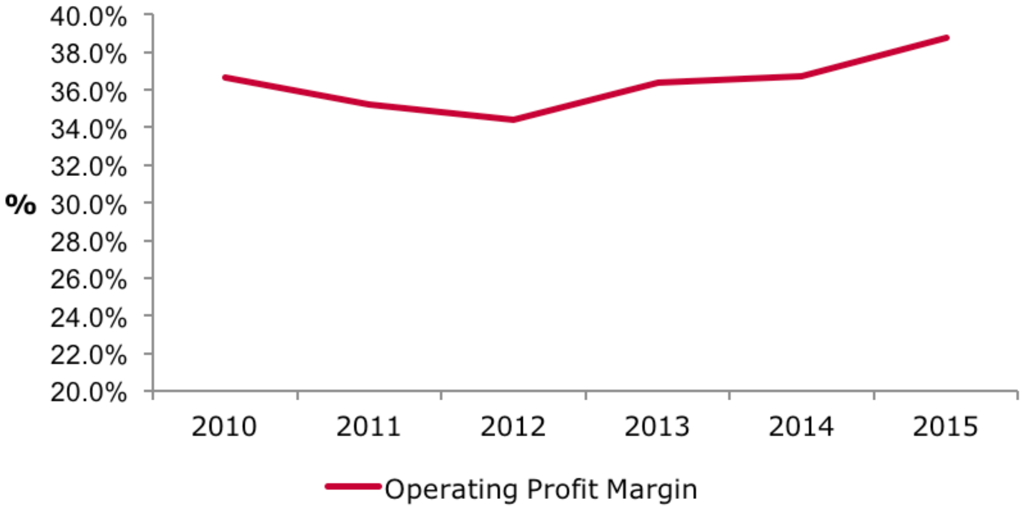
6.87 We analysed the profitability of the asset management sector. Firms in a competitive market would generally be subject to competitive forces which bring profits down towards a normal rate of return over time, typically proxied by the firm's cost of capital for that activity. There are likely to be year on year fluctuations in profitability. However, where firms in a sector or industry generate profits above a normal rate for that activity over a sustained period, it may indicate that competition is not working effectively for those services.

Asset managers have consistently earned substantial profits

6.88 We find that the operating margin earned by asset managers is significant.[235] As shown in Figure 6.19 below, the money weighted average operating margin across our sample of 16 asset management firms is between 34-39% over 2010 – 2015. Trends in operating margins are variable between firms. For about half of the firms in our sample operating margins are largely flat from 2010-2015. However, for most of the remaining firms, operating margins grew over the period. Typically we find that firms who reported margins below average in the 2010-2011 period had recovered to close to the industry average in the later periods of the sample.

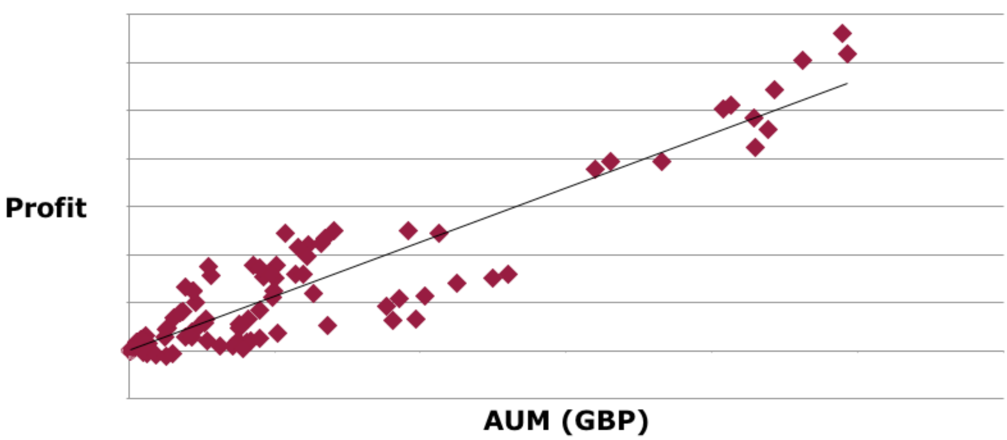
235 Operating margin is defined as operating profit divided by total revenue. Operating profit is defined as revenue less operating cost (staff plus non staff cost) or earnings before interest and tax (EBIT)

Figure 6.19: Average operating profit margin



6.89 We find that profit is also correlated with AUM, as shown in Figure 6.20[236]. Larger firms' revenue increases as AUM increases, consistent with the ad valorem pricing model (charges are a % of AUM). We also find that whilst costs increase with AUM they do so at a slower rate with larger firms typically making larger profits. We also find that larger firms can benefit from economies of scale with cost per £ AUM falling as AUM increases.

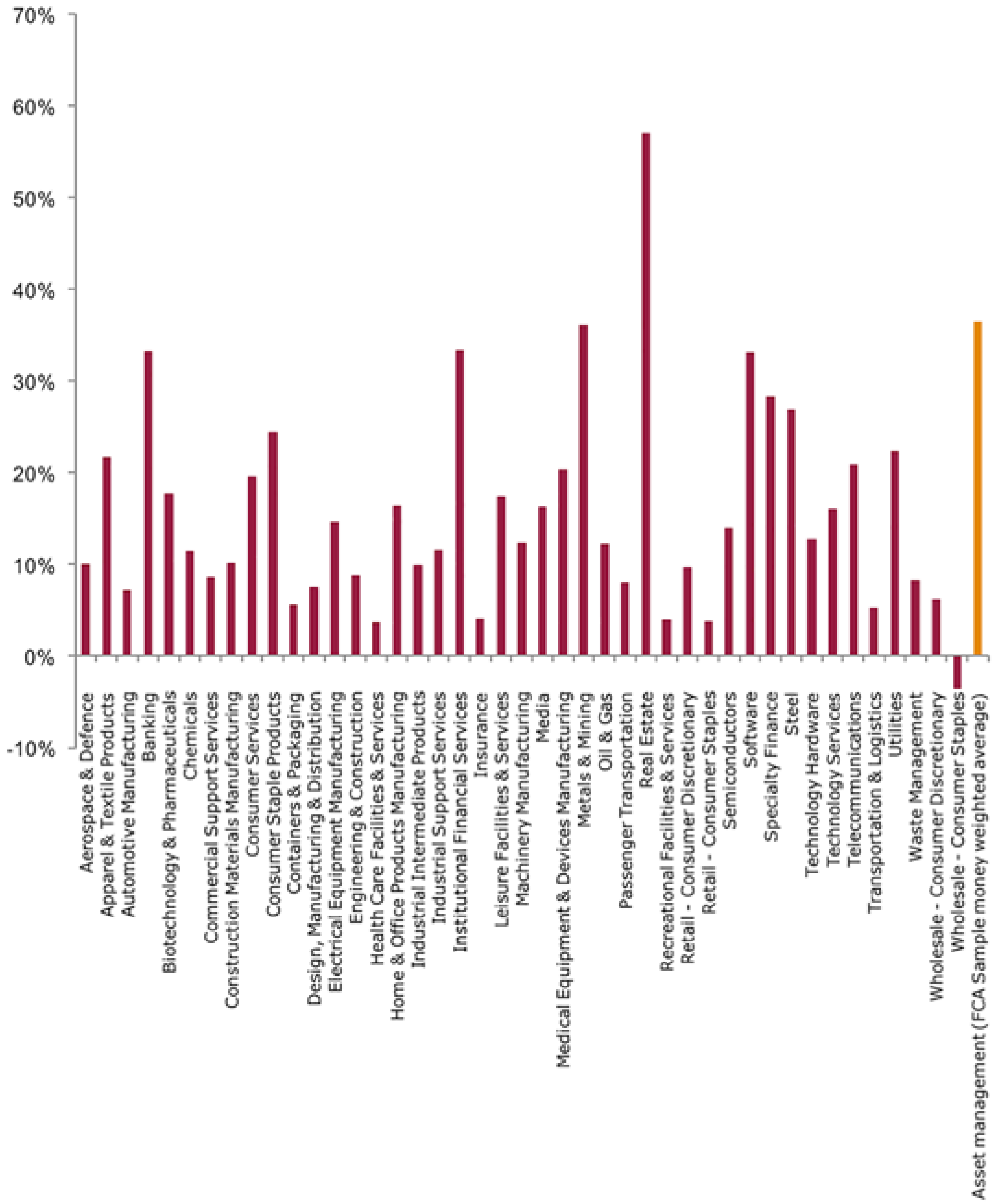
Figure 6.20: Profit plotted against AUM for each firm in each year



6.90 When we compare these operating margins to other industry groups, they appear high. The average margins of the firms in the FTSE All share (including asset management firms) was around 16% with only one industry group (property investments) achieving margins above the average margin found in our data. A comparison of industry groups with similar business structures (high human capital, relatively low physical or financial capital) found margins in the 4%-33% range. Half of the asset management firms in our sample had an average operating margin above 30%. Three quarters of firms had an average operating margin above 20%.

236 The chart above is presented without scales to preserve confidentiality of individual firms.

Figure 6.21: 10 year operating margins by industry (H2 2006 - H1 2016)



Source: Bloomberg

6.91 Of the 13 asset managers that provided financial data to enable us to undertake an assessment of the return on capital employed (ROCE), the ROCE is typically between 20%-45%. These returns are high relative to our estimates of the returns expected by investors' investing in a standalone UK asset management firm. We considered a range of different assumptions leading to estimates of the cost of capital between 5.5-8.5%. We use a cost of capital of 7.6% in the main line of our analysis and find that unadjusted returns are significantly above this benchmark.[237] However these figures are typically used as hurdle rate for the return on seed

237 Our cost of capital estimates are discussed in Annex 8 paragraph 54.

capital invested in new funds. The risk on these projects would be far higher than for asset managers as a whole and so are inappropriate as benchmarks in our analysis.

6.92 We made adjustments[238] to the reported ROCE figures for two reasons:

- The capital base calculated using accounting data is likely to be understated as it does not include intangible assets such as brand, goodwill or the economic value of expertise and other human capital. We have considered different methods for adjusting the capital base, including uplifting it to reflect the differences between the economic valuation of firms during acquisitions and the accounting value of firms balance sheets. However, this represents an upper bound for the capital base as the purchase price would be expected to reflect the discounted cash flow from the business which includes revenues based on current prices which may be above the competitive level.

- The margins reported are after the firm has paid bonuses and wages to staff. In an industry where a significant proportion of revenues go to front line staff (fund managers, research and sales staff), it can be argued that these staff members participate in some form of profit sharing. This is typically taken in the form of remuneration for asset management employees rather than a share of profits as for law firms or consultancies. Furthermore, as explained above, for some firms bonuses are explicitly linked to firm profitability. We therefore think that reported ROCE figures will understate the returns for investment management and have made adjustments to add back the bonuses earned by front line staff.[239]

6.93 Having made these adjustments, we find that the majority of firms earn a ROCE of between 10-25% over the period of our sample, with a money weighted average ROCE of 12.7%.

6.94 In the main line of our analysis, all of the firms in our sample of 13 make adjusted returns above our estimate of the cost of capital over a sustained period of time. Where we have used upper bound estimates of the capital multiplier or a higher weighted average cost of capital we find that one firm out of 13 does drop below the cost of capital by less than 1 percentage point.

6.95 Firms have provided data on a best endeavour basis and our analysis relies on adjustments that are themselves an estimate. We have tested the sensitivity of our results but they remain an estimate of economic profit. Despite this, all the data provided suggest that profitability is high relative to market benchmarks and so we conclude that the results of our analysis are consistent with competition not working as effectively as it could.

6.96 Our data set covers 6 years and begins at the start of the recovery of the industry after the financial crisis. It is possible that financial performance may decline for asset managers in the future due to macroeconomic cyclicality, though the effect of national macro conditions on a global firm with a highly diversified product offering may be relatively muted.

Profits are higher for retail, money market and equity funds but the profitability of active and passive strategies is extremely variable between different providers.

6.97 Within our analysis, we also considered differences in operating margins between different investor types, asset classes and investment strategies.

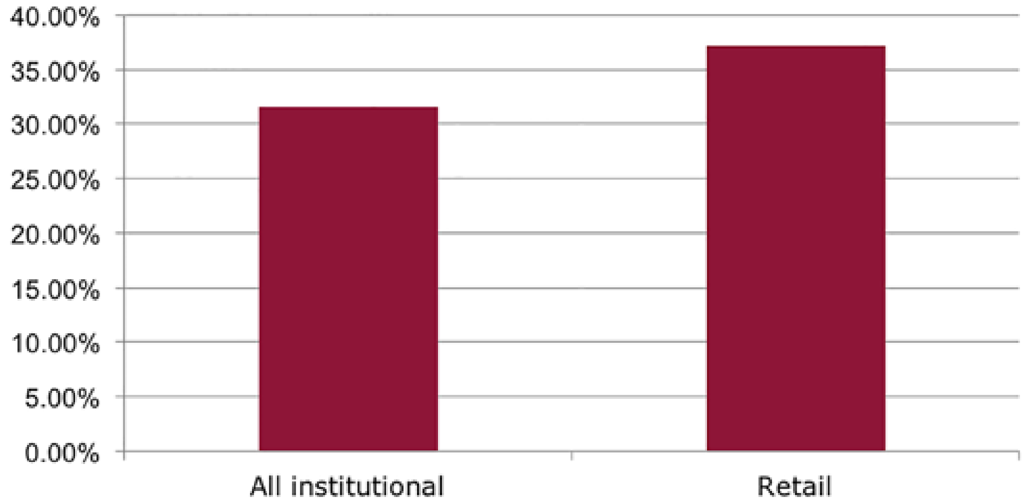
6.98 Overall, we find that operating margins are higher for retail products than institutional products (as shown in Figure 6.22). Adjusting for the relative size of the assets under management, we find that revenues from retail clients are higher than institutional. We also find that the costs

238 We set out the adjustment made to the ROCE in more detail in Annex 8.

239 We have assumed that 48% of the bonus pot can be allocated to front line staff.

of servicing retail clients are higher than institutional clients, although costs increase by a lower amount and hence the higher operating margin. As noted above this may be indicative of less competitive pressure in the retail market. However, it is worth noting that operating margin may not be the only factor influencing firms' business decisions. Retail clients typically form a much smaller cohort than institutional clients and a firm may place more emphasis on institutional clients earning a lower margin but generating a larger overall profit from the greater scale offered by institutional clients. By pursuing a larger overall scale the asset manager may also be able to improve margins across all client groups as economies to scale increase.

Figure 6.22: Operating margin 2010 – 2015



6.99 Finally we considered differences between active and passive strategies. Our analysis does not show any trends that are consistent across the market. Margins are similar on average between active and passive products, being close to industry averages as a whole. However the money weighted average margin is higher for passive products than active products, though the arithmetic average profit margin on active products is higher. We found significant variation in performance between active and passive funds between firms. We note that absolute profit and profit per £ of AUM is higher for active compared to passive strategies. We also found that for firms engaged in both active and passive strategies more firms in our sample made higher revenues on their active than their passive products. For some of these firms the passive component of their portfolio is smaller than the active segment. This might reflect a lack of efficiency savings on the passive side of the business or greater experience in the firm in dealing with active products.

Questions for discussion and next steps

6.100 This chapter has assessed outcomes for investors by looking at pricing, performance and profitability. We will do further work between now and the final report on:

- The finding that investors do not beat the market benchmark after costs. Specifically, we will use factor-based models to explore whether benchmarks reflect the risk the managers are taking on.

- **Fund mergers:** we have found that a significant proportion of funds that underperform their benchmark and/or peers are merged. We will do further analysis to assess what happens to fund performance when funds have been merged and how fund mergers may affect investors' perception of fund performance.

- **Fees and performance:** We will look into this area further after the interim report and welcome views and evidence from interested parties.

7. Are asset managers willing and able to control costs along the value chain?

We looked at how asset managers control costs and quality of third party services. We find that:

- charges to third parties appointed by asset managers consistute around 20% of the total fund charges, albeit with sigificant variance around the average.
- third party charges are generally transparent to asset managers who, in turn, disclose them to investors. For the most part these are clear and transparent, the exception being transaction costs. Whilst the revenue taken by asset managers as an Annual Management Charge is clear, we are concerned that risk-free box profits are opaque and are not passed through to investors.
- procurement of some ancillary services appears broadly appropriate and effective.
- asset managers appear to be less good at controlling transaction costs, although we have observed some progress in this area.
- asset managers are incentivised to control the quality of services by both reputational effects and regulation.
- bundling of ancillary services is frequent but raises no significant competition concerns.
- there may be competition issues in some ancillary services markets (notably transfer agency, index and data provision) which limit asset managers' ability to control price and quality.

Introduction

7.1 Asset managers outsource many products and services to third party providers. Some of the products and services are needed to carry out asset managers' investment management activities. Data services, for example, help managers make investment decisions and execution services enable them to trade on behalf of investors. These products and services are typically purchased on behalf of both investors in funds and segregated mandates.

7.2 Other services are instead bought on behalf of investors to support the running of the fund, for example custody and depositary services. When institutional investors use a segregated mandate they will often choose the ancillary service provider. We have focused our analysis on how asset managers oversee services on behalf of investors.

7.3 When asset managers buy services on behalf of investors to support the effective running of the fund and investment management activities, they are acting as an agent and should act in the best interests of investors. To act as effective agents, managers need to be able and willing to control the costs and quality of the services they oversee.

7.4 In this chapter we explore the following questions:

- how much do investors pay for asset management and other services that support the fund?
- can investors monitor the costs and quality of services paid for out of the fund?
- can asset managers control costs along the value chain?

7.5 Our analysis draws on the data provided by 15 of the 16 firms from which we received detailed financial data.[240] We have analysed the flow of money from the fund and asset management firm to third parties. We also received information from 37 asset management firms about how they oversee their ancillary services and met with 13 ancillary service providers to understand how the market works from their perspective.

7.6 The responses to our request for information and meetings with ancillary service providers show that asset managers outsource ancillary services for a number of reasons including:

- enabling the investment manager to focus on core activities
- benefitting from the expertise and experience available through third parties
- allowing asset managers to manage recent growth and/or create the potential to reach greater scale using outsourced services
- reducing cost
- reducing risk, including operational risk

7.7 Other stated reasons for using ancillary service providers are relevant only for specific services or circumstances, such as the exit of a provider or the location of data or personnel.

7.8 Figure 7.1 below outlines the main services we have considered in this part of our work. Within this chapter, we set out our findings across ancillary products and services more broadly, although we identify relevant findings specific to certain services.

Figure 7.1 services included in this chapter

Service	Description and usual activities included in this service
Custody banking	Safeguarding and separation of assets, trade processing, settlement, managing corporate entitlements (such as proxy voting), tax reclamation
Fund administration (including transfer agency)	A transfer agent is appointed to manage the share register of the fund, maintain ownership records through the registration of investors and handling of subscription and redemption of cash accounts

240 One firm in our sample of 16 was unable to provide data which could be used to assess fund level charges. This is discussed in more detail in Annex 7.

Service	Description and usual activities included in this service
Box management (a type of transfer agency)	In a dual priced fund, where there are buyers and sellers of the fund on the same day, buy and sell orders can be matched with each other without incurring the transaction costs equivalent to those priced into the bid-offer spread. The transfer can be completed by passing all of the dealing of the units through the 'manager's box'. Some asset managers may retain the resultant profit arising from the spread itself which the client has already 'paid' (in the spread) but will not be 'spent' transacting in the market. The asset managers' capital is never at risk in this process as matching is instantaneous
Depositary and trustee services	Oversight of core operator responsibilities including NAV calculations, subscription and redemption processes, income distribution to investors and ensuring compliant investment management
Securities lending	A form of secured lending in which client assets are loaned to a 3rd party for an agreed fee, generating additional revenue on long assets which are shared with the fund
Fund accounting	Bookkeeping and calculation of the fund/mandate's NAV, performance measurement, reporting and performance fee calculation
Foreign exchange	To perform FX transactions to support cross border securities trading and the repatriation of foreign currency income receipts
Middle office	The function of managing risk and calculating profits and losses. Middle office is often also responsible for IT.
Market data services	Pre-trade data services (including terminals) as well as instrument price and trade-related data. Often the information is sourced from trading venues through intermediaries and includes real-time and historical data.
Other data (including post-trade) and analytics	The receipt and use of raw data to identify trends which can inform business and investment decisions. This can include both third party and data that is collected by the asset manager internally.
Index provision	Managers may purchase access to index and benchmark providers to track a market and track and report performance against a benchmark
Research	Information asset managers purchase, either through commission payments or through payments from their own resources, which allows them to identify investment opportunities
Execution	The cost to trade, which can be explicit (e.g. taken as a fee or commission) or implicit (e.g. the difference between the bid and offer prices of a security)

How much do investors pay for asset management and other services that support the fund?

7.9 Investors typically pay for asset management services, the cost of ancillary services (such as custody banking and fund administration) and the cost of trading, which often include costs of third party research.[241] Ancillary service and explicit trading costs are typically paid by investors directly from the fund, although some firms will pay some of these costs themselves. The amount investors pay will depend on how well their fund manager negotiates on their behalf. While these charges will have an impact on net return, without incurring costs investors would not be able to gain exposure to the market and the value of the fund would be unlikely to increase.

241 The implicit cost of trading is the reduction in value of AUM due to implementation shortfall costs which cannot be directly measured in our data set.

7.10 As Figure 7.2 shows, for the firms in our sample[242] we found that in 2015 investors paid approximately 19bps of their total AUM to third parties, in contrast to the 72bps (almost 80% of the charges) which, on average,[243] is paid to the asset manager.[244] The charge to asset managers ranged from 9 to 140bps (though this may include charges they subsequently rebate to consumers). 7 out of 15 firms, have an average charge between 90-140bps and these firms are either primarily or exclusively active asset managers.

Figure 7.2: Average fund charge recipients, for 15 fund managers (2015)[245]

Charge recipient	Total charge	Proportion of fund (bps)	Proportion of charges (%)
Third party	£1079.81 M	19bps	21.0%
Asset manager	£4060.86 M	72bps	79.0%
Total	**£5140.67 M**	**91bps**	**100%**

7.11 In general, we found a wide spread of charges across our sample. While the average payment to third parties was 19bps, the amount paid to third parties varied, with the lowest accounting for 2bps and the highest for 64bps. However, this range is driven by a small number of outliers. 10 out of our sample of 15 firms had third party charges between 10 and 30 bps.

7.12 As part of our analysis we constructed a comparable data set for 11 fund managers that provided a broad split of charges into asset management charges and the key third party services: custody, fund administration and brokerage.[246] The results are presented in Figure 7.3.[247] Our findings for asset managers are in line with our analysis of asset managers' profitability (Annex 8). Here, we find that AMC (or other fees levied for managing the selection of securities) is the main income stream for asset managers, with almost all other income sources tending to be minimal.

7.13 Looking across the breakdown of third party charges, we found that brokerage is the largest cost on average across all funds. Fund administration charges are greater than custody costs. This may reflect the wider role fund administrators play as they try to expand their role by taking over some back office functions previously performed by asset managers in-house.

Figure 7.3: Money weighted breakdown of the core fees for 11 fund managers (2015)

	Charge as % of AUM	Admin	Custody	Brokerage/dealing commission	All Other	Total charge
Average	**0.85%**	**0.03%**	**0.01%**	**0.09%**	**0.14%**	**1.13%**

7.14 Looking at general trends across all assets and strategies, we find that charges tended to decrease on average across our sample period. Comparing this to our profitability analysis we know this has occurred in a period in which AUM has generally risen and both revenue and profit has tended to rise across our sample. This is consistent with increases in profitability primarily being driven by the efficiencies to scale present in the asset management industry.

242 Our sample looks at the fees paid by funds managed by 15 firms. See Annex 7 for more details.

243 All averages in our estimations of the value chain use a money weighted average unless stated otherwise.

244 In the executive summary we explain that the average OCF for actively managed UK equity funds was 0.90% and the average OCF for passively managed UK equity large-cap funds was 0.15%. The total charge in Figures 7.2 and 7.3 are different because they include rebates back to investors, some costs not disclosed in the OCF (such as brokerage costs), and a wider range of asset classes. The figures are also calculated using each funds end of year NAV, rather than the average NAV over a year. This has the potential to both understate or overstate charges compared to headline figures, dependant on both fund performance and inflows.

245 FCA data

246 'Brokerage' includes both research and execution payments for firms that do not incur their own research costs.

247 Note that as our sample size changes our estimate of the funds flowing to both asset managers and third party charges has increased.

However, when we compare this to our pricing analysis in Chapter 6, we find that prices for active equity funds have remained broadly stable over this period. The decrease in charges may reflect the mix of the effect between active and passive, different asset classes and the post-RDR move to clean share classes.

Figure 7.4: Explicit fund charges recipients over time, 2010 – 2015[248]

	Charge Recipient		
Year	**Asset Manager**	**Third Party**	**Total**
2010			
Total Charge £	£1912.86 M	£641.34 M	£2554.2 M
% of AUM	0.80%	0.27%	1.07%
Proportion of charges	74.89%	25.11%	
2011			
Total Charge £	£2475.94 M	£738.44 M	£3214.38 M
% of AUM	0.87%	0.26%	1.13%
Proportion of charges	77.03%	22.97%	
2012			
Total Charge £	£2528.96 M	£696.54 M	£3225.5 M
% of AUM	0.78%	0.21%	0.99%
Proportion of charges	78.41%	21.59%	
2013			
Total Charge £	£3131.13 M	£889.36 M	£4020.49 M
% of AUM	0.75%	0.21%	0.97%
Proportion of charges	77.88%	22.12%	
2014			
Total Charge £	£3683.17 M	£1031.94 M	£4715.11 M
% of AUM	0.71%	0.20%	0.90%
Proportion of charges	78.11%	21.89%	
2015			
Total Charge £	£4060.86 M	£1079.81 M	£5140.67 M
% of AUM	0.72%	0.19%	0.91%
Proportion of charges	78.99%	21.01%	

7.15 The different products in a firm's portfolio can affect the charges paid to third parties and the asset management charge paid to the firm. To understand what drives these differences we have looked at the charges paid to asset managers and third parties by institutional and retail investors. The results for investors in actively managed assets are illustrated in Table 7.5. They show that before rebates back to investors have been taken into account, retail investors paid on average 1.26% in annual management charges whereas institutional investors paid 0.63%.

7.16 It has not been possible to remove rebates paid back to investors from this sample to calculate how much retail investors paid relative to institutional investors for asset management. However, our profitability analysis suggests that asset managers generate both greater revenue and greater profits from retail investors relative to their underlying AUM. We also find that the profit margin earned from retail investments is around 5 percentage points higher on average than institutional investments. Institutional and retail investors also appear to be paying similar

248 FCA data

fees to third parties. Retail investors paid more in admin fees (0.08% retail vs 0.01% institutional) whereas institutional investors paid more in other costs (0.07% retail vs 0.26% institutional).[249]

Figure 7.5: Explicit fund charges for retail and institutional clients in 2015 (ex. Index funds)

Charges (% of AUM)	Retail	Institutional	Mix	Not classified
AMC	1.26%	0.63%	0.75%	0.69%
Admin	0.08%	0.01%	0.01%	0.06%
Custody	0.01%	0.01%	0.01%	0.00%
Broker	0.08%	0.12%	0.11%	0.11%
Other	0.07%	0.26%	0.16%	0.24%
Total charge	1.49%	1.02%	1.04%	1.10%
# of funds	124	89	290	41
Total AUM	**£117. 2 bn**	**£52.74bn**	**£203.2 bn**	**£16.4bn**

7.17 We have also looked at how much investors pay for active and passive funds. As we outlined in Chapter 6, we found that the average OCF for actively managed funds is 0.90%[250] and the average tracker fee is 0.15%.[251] This is lower than the figures in Figure 7.6 below which do not take account of commission payments, some of which are now rebated to the investors. We found that investors pay more explicit trading costs for active rather than passive funds (10 bps vs 0.5 bps per AUM), due, in part, to the greater research costs associated with active investment. Custody charges were similar and administration charges are higher for passive funds.

Figure 7.6 Explicit fund charges for active and passive funds in 2015

Charges (% of AUM)	Active	Passive
AMC	0.887%	0.329%
Administration	0.029%	0.041%
Custody	0.011%	0.009%
Brokerage	0.100%	0.005%
Other	0.148%	0.018%
Total charge	1.175%	0.402%
# of funds	544	31
Total AUM	**£389500. M**	**£25000. M**

7.18 We know from our analysis of the profitability of different asset classes that the AMC on equity products tends to be higher than for other products in the market and this is borne out in the charges data presented in Figure 7.7 below.

7.19 Third party service provider fees do not vary much between different asset classes, with the exception of brokerage cost. The cost of trading will vary depending on how frequently the asset manager trades the particular asset class and the trading venue they use. Our analysis of fund charges by asset class looked at the total cost of brokerage, primarily dealing commission payments for buying shares as a result of changes in fund strategy. We found that for equity assets, brokerage fees were 16 bps.

249 Other costs include performance fees, operational expenses and other sundry charges that could not be constantly allocated across all firms in our sample.

250 The OCF for clean equity share classes

251 Both figures relate to UK equity funds

Figure 7.7: Explicit fund charges by asset class in 2015 (ex. Index funds)

Charges (% of AUM)	Equity	Fixed Income	Allocation	Alternative	Money Market	Property	Convertibles	Miscellaneous
AMC	1.164%	0.652%	1.100%	0.456%	0.123%	0.628%	1.045%	0.589%
Admin	0.026%	0.035%	0.076%	0.004%	0.005%	0.006%	0.057%	0.000%
Custody	0.014%	0.012%	0.005%	0.009%	0.009%	0.002%	0.011%	0.015%
Broker	0.162%	0.002%	0.019%	0.075%	0.000%	0.281%	0.004%	0.000%
Other	0.154%	0.100%	0.082%	0.232%	0.023%	0.372%	0.098%	0.084%
Total charge	1.520%	0.802%	1.282%	0.776%	0.160%	1.289%	1.216%	0.689%
# of funds	265	112	113	27	14	10	2	1
Total AUM	**£176100. M**	**£60340. M**	**£52590. M**	**£53210. M**	**£24010. M**	**£18500. M**	**£3931. M**	**£869.9 M**

Can investors monitor the costs and quality of services paid for out of the fund?

7.20 Asset managers should have an incentive to control the costs and quality of the services they oversee if:

- these costs are taken into account by investors through the charges that are disclosed
- investors monitor and respond to the performance of the fund overall and these costs are a drag on performance as presented to investors, and
- the quality of the underlying services affects investor perceptions of the quality of the service they receive from their asset manager.

7.21 We have explored the extent to which the services which support the running of the fund and asset management activities are transparent and are taken into account by investors, and the extent to which asset managers have sufficient incentives to control costs and quality. The incentives to control costs might be weaker if the service either acts as a revenue stream for the firm, is perceived to generate other benefits to the firm from the third party, or where it is expensive for the firm to oversee the detail of the costs.

Most third party costs are transparent to investors, with exceptions including transaction costs and risk free box profits

7.22 Ancillary service costs appear to be transparent to asset managers. The ancillary service providers we spoke to told us that they provide a detailed fee breakdown to their clients of the cost of services including custody, depositary and trustee services, even where services are bundled. Most asset managers in our sample felt ancillary service cost disclosure was good, and respondents said that there is a good flow of information from the ancillary service provider to asset managers.

7.23 While the costs of most services should therefore be transparent to investors in collective investment vehicles, some service costs are not included in headline rates (such as the OCF) and so are not as transparent to investors. These include:

- **Transaction costs:** Transaction costs are the costs and charges incurred as a result of buying, selling, lending or borrowing investments. Transaction costs can be explicit or implicit[252] and may be an estimate. Implicit costs are not directly billed to the client, but are recognised by market participants and are real costs (for example, the bid-offer spread

252 These costs could be a direct charge (‘explicit’ cost) or could be reflected in the price of the security (‘implicit’ cost).

and market impact). We currently have an open consultation[253] on proposals for rules and guidance to improve the disclosure of transaction costs in defined contribution workplace pensions. In this we are consulting on rules placing a duty on asset managers to provide full disclosure of these costs in a standardised form.[254]

- **Risk free box profits:** Some charges associated with buying and selling the fund are not transparent to investors, for example when risk free box profits are made. While most firms do not retain them, box profit revenues for those that do can be significant. See Box 7.2 for further discussion of this issue.

7.24 As we have discussed, investors (especially retail) are not particularly sensitive to charges, suggesting pressure to control third party costs may be weak. In addition, both retail and institutional investors may not be aware of charges that are not shown in the headline rate. Our survey of retail investors found that, of the respondents who recognised they pay fund charges, only 20% acknowledged paying fund costs and charges which are not included in the ongoing charge. Although our survey of institutional investors found that management fees and fees generally were rated as important factors in their decision making, institutional investors told us that they found some costs difficult to source. Transaction cost information was highlighted as sometimes being difficult to get, making it hard for investors to estimate the likely costs of trades.

7.25 Asset managers may have an incentive to ensure the services they oversee are good quality, or at least to ensure a minimum level of quality is achieved, for reputational reasons. We found that institutional investors consider the manager's reputation when choosing between managers.[255] That said, the retail investors that were interviewed as part of this study did not refer to the quality of the services that support running the fund or asset manager activities when discussing how they assess the value of their products/services.

7.26 Regulation also ensures that asset managers, custodians, depositaries and other regulated firms provide a minimum level of service and safeguard assets. FCA principles (Principle 10) apply to all relevant firms who 'must arrange adequate protection for clients' assets when it is responsible for them'. Firms who, for example, are acting as depositary or trustee for a UCITS or for an AIF are subject to requirements to ensure, among other things, the appropriate holding and depositing of assets as well as recording, accounting and reconciliation. Asset managers also have a regulatory obligation to provide best execution, which requires scrutiny of execution costs and price alongside other factors.

7.27 In principle therefore, managers should have an incentive to control the costs and quality of these services, as most are disclosed to investors through the OCF and because the cost of services will affect net performance. However, exceptions could arise if:

- the costs are not part of the OCF
- the cost of the service does not materially affect net performance over the short term as presented to investors and
- controlling costs reduces revenues or is costly to the manager.

7.28 We discuss these in more detail in the following section.

253 CP16/30, *Transaction cost disclosure in workplace pensions* (October 2016) www.fca.org.uk/publication/consultation/cp16-30.pdf

254 IGCs and trustees are already required to request and report on transaction costs as far as they are able.

255 See Annex 5

Can asset managers control costs and quality along the value chain?

7.29 We have looked at asset managers' purchasing practices to assess what these suggest about their ability and willingness to control cost and quality. We have explored:

- how asset managers purchase services on behalf of investors
- whether asset managers are able to get value from the ancillary services that they purchase.

Asset managers purchase services through professional procurement processes

7.30 Ancillary services are typically purchased through a procurement process where managers consider alternatives and negotiate with providers. As illustrated in Box 7.1, all the asset managers in our sample ran a relatively standardised tendering process, from initial Requests for Information through to implementation of the service.

7.31 Many ancillary services are not frequently switched. We heard from some firms who had not switched their largest ten funds or segregated mandates' custody or ancillary service providers within the last ten years.[256] Some firms had switched more recently but their previous contracts had lasted for more than ten years. However, we also heard that procurement policies may include schedules which require periodic re-tenders, for example, once every three years. Services which asset managers had switched included custody, fund administration and reporting, accounting and valuation and transfer agency.[257] As services are not bought frequently, this raises a question about how effectively asset managers actually procure them, as they may not be familiar with the prevailing market price or expected level of quality.

7.32 However, all the ancillary service providers we spoke to suggested that investment consultants can help managers to procure services. Some asset managers may also know about multiple service providers, for example through managing segregated mandates, giving them more information about current market conditions. Therefore, for the main ancillary services we conclude that asset managers generally understand what they are purchasing, run effective tendering processes and mitigate the potential risks from infrequent retendering.

256 Where a segregated mandate's service provider was switched this may not have been at the discretion or even with the involvement of the asset manager in question.

257 Some of these services were bundled.

Box 7.1 – The tendering process for ancillary services

Asset managers in our sample and ancillary service providers we spoke to described a tendering process which is used to purchase new services or to retender for a new provider.

Common aspects of the tendering process are:

1. An initial Request for Information (RFI)/Request for Proposal (RFP). *When supported by consultants this is often using a common template.*
2. Questions and interrogation stage in response to the RFI/RFP. *Both potential provider and service user ask questions of one another and clarify their position at this stage.*
3. A shortlisting process sometimes including '*beauty parades*' of providers. *Where relevant this is supported by a consultant, legal adviser or another independent adviser.*
4. A round of negotiation directly with the two to three shortlisted providers.
5. Provider selection.
6. Implementation phase. *This phase varies significantly depending on the particular service.*
7. Completion – service is fully operational.

7.33 Asset managers appear to take the quality of service into account when buying 'core' ancillary services, including custody, trustee and depositary services, fund accounting and transfer agency. The ancillary service providers we spoke to suggested that the capabilities, as well as breadth and depth of services on offer, were key reasons that asset managers selected one service provider over another. In some cases, quality of service was more important to asset managers than price. Quality was a focal point for negotiations, with firms benchmarking the performance of providers against their competitors.

7.34 For services that require less customisation or are more easily compared across providers, such as standard custody services, price is a feature of negotiations and ancillary service providers appear to be willing to negotiate on price.

Competition appears to be working effectively in most ancillary service markets, allowing asset managers to control costs and quality

7.35 Asset managers will be less able to control costs and quality if competition is not working effectively in the markets they buy from. If asset managers face limited choice and cannot switch to alternative suppliers, they may not be able to place pressure on current providers and negotiate effectively. We asked asset managers and ancillary service providers how competition works for the services asset managers oversee on behalf of investors.

7.36 Some ancillary service markets, for example custody banking, retail transfer agency and data provision, appear to be relatively concentrated. We were told by the largest transfer agent in the UK market that they estimate they have 65% market share. We estimate that the top three custody banks represent approximately 55% of assets under custody in the UK, and the top seven firms represent approximately 85%.[258] Pre-trade data are predominantly delivered by one or both of the two main providers, which represent more than 55% of the market when combined, though smaller specialist providers exist.[259]

7.37 Generally, the likelihood of new entrants into many ancillary service markets is low, given that services are capital resource intensive and profitability often depends on achieving significant scale. In particular, custody banking and fund accounting providers benefit from scale, which may act as a barrier to completely new entrants. We were told that asset managers prefer custody banks with a presence in multiple jurisdictions, meaning that a global business network was often a requirement for winning business from asset managers. Providers also suggested that custody and fund accounting requires major IT infrastructure, which demands significant provider scale and may prevent entry by new firms.

7.38 We were told by ancillary service providers that incumbent firms face the threat of competition from overseas firms. Such firms may already have the global network that managers value and have sufficient infrastructure in place to make expansion into the UK market possible. However, we have not seen firms gaining significant market share from the main ancillary service providers in custody, fund accounting, trustee or depositary. Further in-depth analysis is needed to conclude whether firms in overseas markets act as a source of competitive constraint.

7.39 We found that it is more complicated, costly and time consuming to switch certain ancillary services. Implementation times varied from a few days to a number of years depending on the service being switched.[260] Asset managers found, for example, middle office, investment accounting and transfer agency difficult to switch while switching legal adviser was more straightforward. Despite this, we have found examples of asset managers that have switched away from their service providers due to high prices, low provider quality and/or lack of capabilities in new required services. The services switched varied across asset managers though the most frequent were custody, transfer agency and fund accounting.

7.40 Although asset managers do not frequently switch services, providers face ongoing pressure from them. During contract periods, asset managers may renew and renegotiate services and so these services are increasingly tailored to the users' needs. Where services are reviewed, asset managers may demand changes on price and quality based on their knowledge of alternative providers' offers. We heard that asset managers may use knowledge gained from oversight of their segregated mandates' service providers to inform choices for their own funds. For certain services, asset managers can use third party reviewers or consultants who can compare multiple service providers. We have observed pressure from asset managers in most ancillary service markets.

7.41 Some asset managers that responded to our information request said competition may not be working well in both index and data provision. Asset managers told us that they may have little choice or opportunity to switch to another index provider, even if quality is poor or prices too high. This is particularly common when the index is the market standard and when it is complex to move to a new index because of the need to change internal systems and documentation. It may be difficult to switch to an alternative data provider when the provider generates data from their link to a key trading venue, or where data are provided as part of a package which includes services otherwise important for the managers' business including transaction or connected messaging services.

258 Estimates based on FCA internal sources, market shares calculated on the basis of assets under custody.

259 Based on global spend on market data in 2015. Burton-Taylor International Consulting LLC *Market Data/Analysis Spend – 2016 (Global Market Share and Global Segment Sizing)* Sample of data available at the following link https://burton-taylor.com/wp-content/uploads/2016/03/B-T-Global-Market-Data-Analysis-Competitor-Segment-Sizing-2016-Information-Kit.pdf

260 These timeframes are to the date that the service is fully operational.

7.42 Additionally, we have heard that some asset managers are concerned that as costs in pre-trade data increase these are not matched by innovation or improved service. They are also concerned about pricing practices, in particular charging a percentage of total assets for indices used by only part of the business. Nevertheless, some respondents were satisfied with the quality of the service received from their index and data providers and we have seen new entrants in the last year in index provision.[261]

7.43 Ancillary service firms told us that it was difficult to operate some services at a profit. For example, transfer agency has the lowest margin[262] due to rising costs triggered by increased risk management, data and technology enhancements and regulatory activity. As a result, there are very few transfer agency providers, particularly retail, in the UK market, with some firms recently leaving the market and few remaining to compete with the largest provider. Some asset managers said that the concentration of the transfer agency market was creating weaker negotiating positions for asset managers, a potential lack of innovation in current service offering and a risk of wider market impact if the current leading provider fails or has a significant IT problem.

Bundling ancillary services does not appear to affect asset managers' ability to get value from the ancillary services they purchase

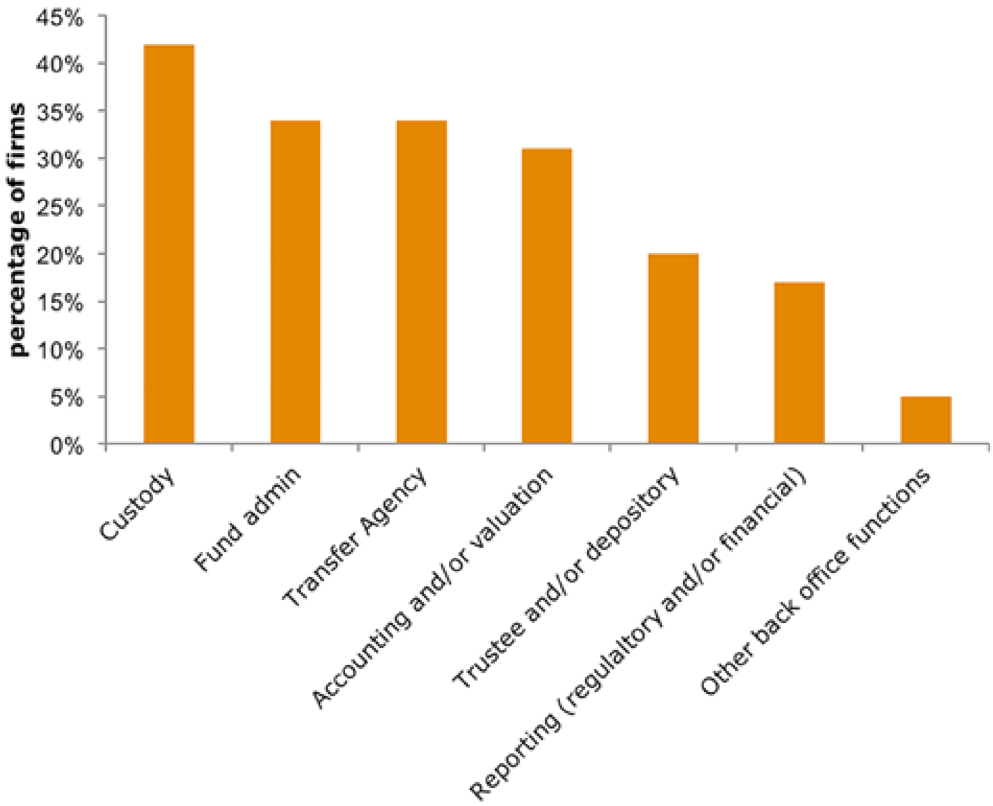
7.44 Many ancillary service providers offer a range of services and typically sell services in a package to asset managers. In our sample of asset managers, 65% of firms said they buy at least two of their ancillary services in a package or 'bundle'.[263] Some services are more likely to be bought in a bundle than others; the most common bundle contained both custody and fund accounting.[264] Global custody is often bundled with depositary services, and the two together are also often combined with fund administration.

7.45 We considered whether bundling practices create competition concerns. Bundling could make it difficult to negotiate on the costs of individual services that make up the bundle. It may also make it difficult for stand-alone service providers to compete. For example, if a custody provider required asset managers to buy non-custody services from them, this could make it difficult for providers of non-custody ancillary services to compete, particularly if managers have little choice about where to buy their custody services.

7.46 On the other hand, bundling can be positive for clients, particularly where firms benefit from economies of scope in providing multiple products and can pass these cost savings on to their clients. This is more likely to be the case where there is competition between providers of bundled services.

261 www.ft.com/content/082b7ba6-307e-11e6-bda0-04585c31b153
262 Compared to trustee, depositary, global custody, fund accounting, securities lending and foreign exchange
263 A bundle here refers to purchasing more than one ancillary service from the same provider, not bundling of research and execution.
264 Respondents provided us with information regarding more than 35 different bundles of services.

Figure 7.8 – The services most commonly purchased as part of a bundle by our sample of asset managers[265]



Source – FCA internal data

7.47 Some services such as retail transfer agency are not bundled with other services in the UK, despite being offered as part of a bundle in other jurisdictions. Foreign exchange services, particularly large scale transactions, are not necessarily executed by the asset management firm's existing service provider. Other services are considered as part of a bundle by some service providers, but as a standalone service by others, depending on the service providers' business model. For example, middle office was considered independent to other services by one provider while another was unlikely to give a client middle office unless they also bought other services.

7.48 Generally, service providers told us that the main reason why they bundle services is to achieve economies of scale and scope.[266] Some providers explained that one service was the 'core' service from which other services were then added to the 'package'. In this case some additional services can be offered at a lower fee than if they were offered independently due to efficiencies such as:

- Compatibility and/or integration of systems used for multiple services. We were told that the reconciliation costs when trying to use two different systems can be very high. Splitting custody and fund accounting, for example, can add an extra layer of cost for asset managers due to the additional checks and controls that their fund accountant would need to do.

265 The findings for custody should be taken with caution. At least two of the firms noted that they had included custody as a bundled service in their response despite the custodian in question being appointed by the asset owner.

266 Economies of scope arise when the average cost of production falls as the range of products produced increases

- Reduced joining costs when adding an additional service for an existing client when compared with the discovery work that would be required for a new client. We were told that on-boarding new clients can take up to ten months.

- Natural synergies between similar or linked services, particularly where the effective delivery of one service is contingent on another service.

7.49 The potential efficiencies from bundling appear to be passed on to asset managers. More than two thirds of the asset managers that responded to our information request gave price as the main reason they bought a bundle of services.

7.50 Providing services in a bundle does seem to prevent asset managers from negotiating and controlling the individual components of the bundle. Information from our sample of asset managers and ancillary service providers suggests ancillary services are rarely supplied in a 'pure' bundle.[267] Of the bundles asset managers gave us further information on, 57% of them explicitly stated that bundled services were negotiated, contracted and invoiced separately.[268] Asset managers told us that it was possible to understand the costs of the individual parts of the bundle and that they can negotiate on the individual components of the bundle.

7.51 One provider told us that they bundle fund administration, transfer agency and depositary services to allow for a coordinated operating model and for maximum bargaining power in contractual and fee negotiations. However, they also told us that each service is priced separately in contractual clauses to allow direct comparison of the fees charged by alternative suppliers. The contracts are written in such a way that individual services can be terminated with no immediate impact on the fees for the other services. There are also material-change clauses which, if triggered, may result in the renegotiation of the contract.

7.52 As asset managers predominantly[269] buy ancillary services in a mixed bundle[270] this suggests that stand-alone service providers would be able to compete if they offer their products at a competitive price. This is because asset managers are typically not required to buy a package of services on a 'take it or leave it' basis,[271] which would make it difficult for single service providers to remain in the market. The existence of individual ancillary service providers also implies that they are able to compete for this business. Providers are, however, likely to have an advantage over others if they have an existing relationship with an asset manager and bundling is likely to offer an opportunity to increase revenue.

7.53 Our evidence here is largely based on discussions with, and about, larger asset managers. However, smaller asset managers may not have as much buyer power which may affect how they are able to purchase a package of services. In Chapter 9 we discuss the interaction with Authorised Corporate Directors as a potential method to aggregate smaller funds to increase their buyer power when buying ancillary services.

Where costs are less transparent, we have identified some specific examples where firms place less emphasis on controlling them

7.54 The cost of trading is less transparent to investors than ancillary services that are paid for as part of the OCF. When an asset manager transacts on behalf of a pension scheme or fund, some

267 A pure bundle is when goods or services cannot be purchased separately

268 Providers told us they provide rate cards to asset managers which breaks down the costs of a package of services into its component parts.

269 With the potential exception of 'terminal'-based data services.

270 Mixed bundling occurs when the consumers can purchase services individually or as part of the bundle

271 Only one asset manager in our sample indicated that they had experienced some 'reluctance' on the part of providers to supply services unbundled.

costs that are incurred are explicit. Explicit costs are the direct costs of transacting. Examples of explicit costs are commissions charged on orders executed by brokers. These costs can include the cost to execute transactions and the cost of research from brokers, fees charged by custodians for clearing and settlement and taxes such as stamp duty. Asset managers also incur other costs when they transact which are implicit. There are a number of different types of implicit cost presented in transaction cost research,[272] which often include bid-offer spread, market impact and missed trade opportunity and delay costs.

7.55 Currently, the OCF does not include explicit or implicit transaction costs and under current disclosure requirements there is no obligation for an asset manager of a pension scheme to provide information on transaction costs. However, we have recently published proposed rules and guidance aimed at standardising the disclosure of transaction costs incurred by DC pension investments.[273]

7.56 Historically, research costs have been incurred as a trading cost (as research and execution costs were bundled into dealing commissions). Research costs should not need to be driven by the frequency of trading and bundling research with other trading costs does not necessarily encourage firms to set a research budget and control the costs. Since 2006, the FCA and its predecessor the Financial Services Authority (FSA) have therefore sought to move asset management firms towards unbundling the payment for research from execution costs, and to spend clients' money on research as if it were their own in order to create stronger incentives to control these research costs. The recent history is as follows:

- In 2011-12, the FSA tested how well firms had implemented 2006 rule changes on the use of dealing commissions to pay for research. It found that many of the firms had made little progress and that some asset managers were breaching FCA rules around the use of dealing commissions.[274]

- Following the review, the FCA consulted on changes to rules in 2013-14, chiefly tightening the evidential provisions on what can constitute 'substantive research', explicitly requiring mixed use assessments for payment for research bundling with market data services and prohibiting payments for corporate access. The new rules were introduced in June 2014.[275]

- In 2014, the FCA conducted further work into how firms are controlling research costs, which concluded that there were still too few firms applying sufficient rigour in assessing the value of the research services they use.[276] Supervision of 25 further firms took place in 2016.

272 *Transaction Costs Transparency – Prepared for the FCA by Novarca* (December 2014) www.fca.org.uk/publication/research/transaction-costs-transparency-research.pdf

273 CP 16/30, *Transaction Cost Disclosure Workplace Pensions* (October 2016) www.fca.org.uk/publications/consultation-papers/cp16-30-transaction-cost-disclosure-workplace-pensions

274 FCA Handbook COBS 11.6 www.handbook.fca.org.uk/handbook/COBS/11/6.html

275 CP13/17, see: www.fca.org.uk/publications/consultation-papers/cp13-17-use-dealing-commission

276 The findings of this work were published in DP 14/03 *Discussion on the use of dealing commission regime: Feedback on our thematic supervisory review and policy debate on the market for research* www.fca.org.uk/publication/discussion/dp14-03.pdf

- In recent months, a small number of asset management firms have announced a move to full unbundling ahead of MiFID II, which will introduce a requirement that execution fees are separated from research fees, whereby the firm will either need to meet the cost of broker research from its own resources or present the client with a separate, upfront research charge which must be based on a fixed research budget, not linked to transaction volumes or values. This research charge and subsequent payments to providers must be controlled through a 'research payment account', which is subject to specific oversight and disclosure requirements.[277]

7.57 Our data on dealing commissions incurred by active equity assets suggests firms have improved control over research costs. We hold data on the dealing commissions paid by 31 mainstream and alternative asset and wealth management firms of various sizes, collected as part of our market based supervision of firms' use of dealing commissions. The data suggest that research and execution spending has decreased since 2012.

7.58 Our 2016 supervisory work found that the majority of firms sampled now set budgets for research spending. Once budgets have been met, firms often switch to trading on execution only rates, suggesting that setting budgets goes some way to firms unbundling research and commission spends. A minority of firms were meeting a greater portion of the research budget from their own resources than in previous years. Some firms could also demonstrate they had negotiated better commission rates for their funds.

7.59 However, we have concluded that most firms are still not applying the same rigour and oversight to the way in which they spend clients' research budgets as when they spend their own money. Research budgets, where set, are still predominantly linked to historical research consumption levels which were primarily driven by transaction volumes, as opposed to a robust assessment of the value of the substantive research received. Practices for evidencing, challenging and validating how they use substantive research remain varied. We remain concerned that a minority of firms are continuing to use client dealing commissions for services which we have explicitly deemed ineligible for payment from commissions, such as corporate access and market data services. Where this has been found we are addressing this on a firm specific basis and where deemed appropriate, a referral for investigation will be considered.

7.60 As well as considering how firms control the cost of research, we have also looked at how firms are approaching their best execution requirements. We published the Best Execution and Payment for Order Flow thematic review in July 2014.[278] Asset managers were not directly involved in the initial sample of firms but we have since conducted multi-firm supervisory work as a follow-up to this thematic review to find out how asset managers have implemented the changes we called for.

7.61 Within this multi-firm review of best execution arrangements in asset management firms, we visited eight firms in 2016. The firms which demonstrated a decrease in the cost of equity trading in recent years showed an increase in the use of low cost trading venues such as broker-supplied algorithms, direct market access and the increasing use of crossing networks for appropriate trades. These firms had an effective governance process in place that challenged the overall costs of execution, renegotiated commissions on an annual basis and could identify trends that helped improve future execution and fed into a high level trading strategy.

277 For more detail on the MiFID II reforms and the FCA's implementation approach, see Chapter 3 of CP16/29: www.fca.org.uk/publications/consultation-papers/cp16-29-mifid-ii-implementation

278 TR14/13 – *Best execution and payment for order flow* www.fca.org.uk/publications/thematic-reviews/tr14-13-best-execution-and-payment-order-flow

7.62 All the firms we visited had management information that allowed them to accurately view equity execution costs. However, the way these data were used was mixed and not all firms could demonstrate the improvements they had made to their execution process based on these data.

7.63 Firms who managed fixed income products found it more difficult to evidence that they were minimising costs. This is partly because of the limited liquidity of some fixed income securities, making comparison of the firm's trading with that of other participants less straightforward. In addition, the over the counter (OTC) nature of the product, where the cost of dealing is contained in the price spread and is therefore less transparent than equity commissions may make it difficult to minimise costs. This is an asset class where price transparency is improving as more trades are conducted through electronic venues where price comparison is more readily available and firms can demonstrate whether they achieved the best price (narrowest spread) available at the time.

7.64 For large fixed income trades (and other OTC products) where only one counterparty is approached, to minimise information leakage, there is currently little challenge or governance concerning the choice of counterparty and whether any potential conflicts (such as inducements from brokers) influenced the choice of counterparty. Firms may need to improve their procedures for this type of trade as MiFID II requires firms to check the fairness of the price for OTC transactions and introduces an explicit measure to ensure a good outcome for the client.

7.65 The cost of trading foreign exchange has been less transparent to service users in the past, although service providers told us they have been making efforts to increase the quality of disclosures. For example, trade timestamps are more frequently included in reporting when requested by asset managers, which makes it easier for them to assess whether the transaction was executed at the best available price. However, a few of the largest service providers are still unable to provide this information. Additionally, transaction cost analysis undertaken by asset managers is increasing the availability of information on execution quality and helping asset managers choose their provider.

7.66 In 2013 we conducted a thematic review into the governance of unit-linked funds which looked at the standards of control firms operated over securities lending.[279] Securities lending (or 'stock lending') is the practice of lending securities (e.g. shares) from one party to another. The insurer receives a fee for lending its assets and the borrower can use the borrowed asset to support its investment strategy. This practice can involve risk should the borrowing party fail, or otherwise be unable to return the borrowed security. The insurer will receive some form of collateral to minimise their loss should this occur.

7.67 The review found that firms that engaged in stock lending operated high standards of control – this included the collateral standards set and the ongoing monitoring of stock lending operations. This was generally in firms' interests as they typically indemnified unit-linked customers against the risks arising from stock lending – where they did not, we found that disclosures to customers were appropriate. We also found that most firms allocated a fair share of revenues from stock lending to the fund.

7.68 We considered how 11 asset management firms manage the 'risk free box profits' made from dual priced funds. Transactional box profits are derived from the prices that customers pay for fund units. The findings are summarised in Box 7.2. We estimate that in 2014 over £63m was retained by asset managers by making risk-free transactional box profits in dual priced funds.[280]

279 TR1/8 *The governance of unit-linked funds* www.fca.org.uk/publication/thematic-reviews/tr13-08.pdf

280 FCA data, company filings

Box 7.2: Box management and risk free box profits in dual priced funds

In dual priced funds the bid-offer spread between prices to buy and sell the fund reflects the costs of buying or selling the underlying securities needed to create or cancel units. This means that when customers enter or exit the fund, the costs of their transactions do not dilute the value of existing unit holders' units.

Where there are buyers and sellers of the fund on the same day, buy and sell orders can be matched with each other without incurring the transaction costs priced into the bid-offer spread. This is because existing units can be transferred from the selling customer to the buying customer without any need to buy and sell the underlying securities. The transfer can be completed by passing all of the dealing of the units through the 'manager's box'. Some asset managers take the resulting money from the spread itself which the client has already 'paid' but will not be 'spent' transacting in the market. The asset managers' capital is never at risk in this process as matching is instantaneous.[268] Where the money is retained by the asset manager rather than paying it into the fund for the benefit of the fund's investors the revenue can be significant, amounting for some firms to as much as between £5.6m and £15.75m, equivalent to as much as 10% of group revenues or 0.05% of the affected assets under management.

In contrast, when units in single priced funds are bought and sold, customers buy and sell units at the same price. Therefore, the manager receives the benefits from not having to trade underlying investments.

Are investors able to monitor box management costs?

Box profits are reflected in the net performance which is disclosed to investors. This is because if the manager had not taken a nominal spread from investors entering and leaving the fund then this money could have stayed in the fund and performance would, all things being equal, have been better.

However, which individual customers pay for the transaction costs to avoid dilution to existing unit holders, and which are contributing to the asset manager's box profit is entirely arbitrary. It depends on how many matching orders there are from other investors on the same day and the size of those orders. It is therefore not possible to tell, either from forecasts or after the event, if the price any one customer has paid for their units covered the costs of their transaction or contributed to the asset manager's box profit. There is thus no opportunity for investors to scrutinise this cost

Questions for discussion and next steps

7.69 This chapter has looked at whether asset managers are able and willing to control costs and quality along the value chain. We recognise that cost and charging information is not necessarily presented to institutional investors in a consistent and comparable format. As we highlight in our discussion about potential remedies (Chapter 10), we welcome feedback on what fees and charges information should be made available to investors in standardised disclosure framework.

281 These transactional box profits should be distinguished from profits made from the change in value in a proprietary holding in the units of a fund where the firms' capital is at risk and where the holding of units in the manager's box is used for the benefit of its customers: for example, to stabilise the pricing basis of a fund.

8.
The role of investment consultants

We looked at the role of investment consultants and their impact on outcomes for institutional investors. We find that:

- the investment consultant market is relatively concentrated and switching rates are low
- on average, consultants are not able to identify managers that offer better returns to investors. However, the manager selection process ensures that asset managers meet minimum quality standards and reduce operational risk for investors.
- consultants do not appear to drive significant price competition between asset managers. Consultants do not place a lot of weight on manager fees in their ratings, although in some instances they can help investors in negotiations on price.
- the advice provided by investment consultants on asset allocation and investment strategy is significantly more influential in terms of outcomes than the advice on manager selection. However, many institutional investors struggle to monitor and assess the performance of the advice they receive. There is no standardised framework to assess the quality of advice or help investors assess whether they are achieving value for money.
- for some investors, fiduciary management offers a way to pool their money to achieve lower costs and get wider exposure to different managers and solutions. However, we have concerns about conflicts of interest that arise in fiduciary management, which is increasingly offered by investment consultants and fund managers. These issues are exacerbated because investors cannot assess whether the advice they receive is in their best interests.
- performance and fees of fiduciary managers appear to be among the most opaque parts of the asset management value chain. A lack of publically available, comparable performance information on fiduciary managers also makes it hard for investors to assess value money.

Introduction

8.1 Investment consultants play a significant role in the market for institutional asset management. They provide a range of services mainly to trustees of pension schemes but also to charities, endowment funds, companies, insurance firms and employers who offer contract-based pension schemes.[282] In 2015 the value of institutional assets under management was £3 trillion.

8.2 Investment consultants generally advise clients on investment strategies, asset allocation and manager selection. The influence exerted by investment consultants is significant. The scale of assets affected by their advice is very large, with twelve of the largest investment consultants potentially affecting £1.6tn[283] of assets through their advice.

8.3 In our market study we wanted to understand how institutional investors procure and use asset management services and how asset managers compete to win this business. As part of this, we wanted to gain a better understanding of the relationship between institutional investors, particularly pension trustees, and their investment consultants. We also wanted to understand the role investment consultants play in helping institutional investors get value for money from asset management services.

8.4 In doing so, we considered the following questions:

- How does the advice given by investment consultants affect competition between asset management?
- How are conflicts of interest within investment consultants' business model managed?
- Can clients monitor the services provided by investment consultants?

8.5 As well as meeting with and sending information requests to a sample of investment consultants, we had one-to-one meetings with over 31 institutional investors and conducted an online survey with 89 respondents. We commissioned academic research to look at the effectiveness of oversight committees. We summarise our findings from the pieces of work exploring the institutional market in this chapter and set out the detailed findings from these pieces of work in Annex 5.

Sector overview

8.6 In addition to advising on investment strategies, asset allocation and manager selection, consultants may also provide additional services related to investment management. This can include manager research for institutional investors with in-house expertise and monitoring and reporting investment performance for clients. Other services provided by consultants include advice on the choice of custodian, transition manager[284] or other ancillary service provider. Or they may provide the transition management themselves. Investment consultants are often part of larger organisations which provide actuarial services.

8.7 Some investment consultants act as employee benefit consultants (EBCs). EBCs provide, among other things, advisory and administration services to employers for DC pension schemes, and are an important distribution channel for DC pension products in the UK.

282 A defined contribution pension scheme purchased by an individual, either through their employer or individually, from a pension provider. It is owned entirely by the individual with the contract existing between the individual and the pension provider.

283 Twelve investment consultants gave the FCA estimates of the scale of their client assets under advice. This figure is the total of these estimates for 2015. There is the potential that clients are advised by more than one adviser which means this estimate is likely an upper bound.

284 Transition Management is used by asset owners, such as pension funds, to help move investment portfolios between different managers or markets while managing market risk and reducing transaction costs.

8.8 The advice and recommendations made by consultants to clients on strategic asset allocation is unregulated. Parts of the manager selection and rating processes that consultants undertake is also not regulated. Likewise the advice from EBCs to employers may be provided in a way that is not also regulated.

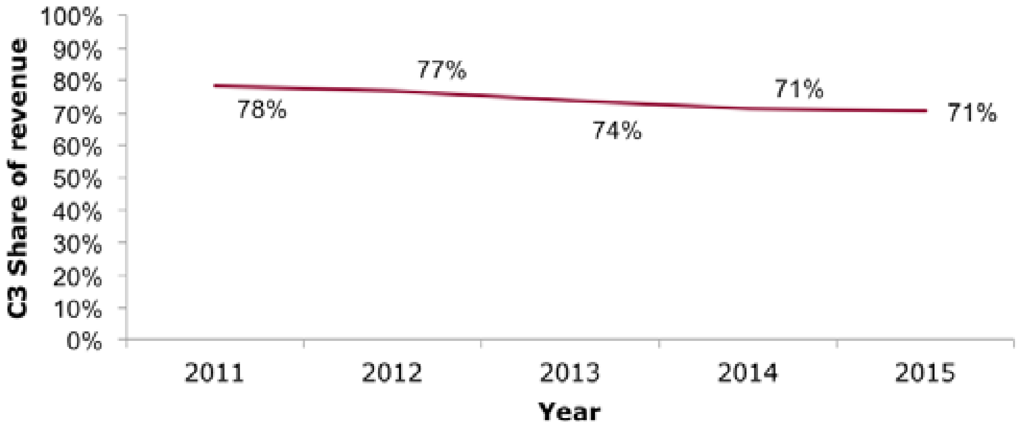
8.9 Some investment consultants now offer fiduciary management services, also called implemented consulting. Here the fiduciary manager selects, appoints and monitors investment managers on behalf of the client and takes responsibility for functions such as portfolio construction and risk management. The consultants may also have discretion to deviate from the original asset allocation decision specified by the client.

8.10 The level of delegation and discretion that the fiduciary manager has can vary depending on the client requirements. Under 'partial delegation' the client places only a subset of assets under fiduciary management whereas 'full delegation' is typically where all of the scheme's assets are under the advice remit and management of the fiduciary manager. Delegation may also vary depending on the degree of decision-making the fiduciary manager is given. Some trustees may be happy for the manager to make most of the decisions as long as they adhere to the agreed mandate while others may want a final say on manager selection or asset allocation.

Concentration

8.11 The investment consultant market is relatively concentrated, with three firms, Aon Hewitt, Mercer and Willis Towers Watson, taking a significant proportion of market share, estimated to be around 60%[285] in 2015.

Figure 8.1 – Relative share of advisory revenues for the three largest investment consultants based on our sample[286]



8.12 Recently the relative share held by the three largest firms has seen a modest decline, with smaller firms gaining ground. Some of these small to mid-sized consultants are specialising in providing services to specific institutional investor groups, for example, charities or local authorities. A few appear to focus on serving smaller institutional investors, in terms of assets invested. Others provide specialist advice on certain asset classes.

285 A sample of twelve of the largest investment consultants provided revenue to the FCA. The largest three had revenues in 2015 totalling 71% of the sample giving us an upper bound estimate. Mandatewire data suggests that this sample covered 76% of mandates advised. As the FCA does not have revenue data on the consultants advising the other 24% of mandates we estimate a lower bound by scaling down 71% by 0.79 providing a range between 56%-71%. The midpoint of these two estimates is 63%.

286 The revenue data collected by the FCA covered 12 of the largest investment consultants but is not exhaustive. The market share estimates are therefore upper bound measures of the share taken by the big three.' Data is for advisory revenues only and does not include revenues for fiduciary management.

8.13 Although the share of revenues of the largest consultants has fallen, some institutional investors we spoke to were concerned about the concentration of the market. This was also reflected in our online survey. A quarter of respondents said that when they tendered for investment consultancy services, only one consultant was able to meet their requirements.[287] This was a greater concern for smaller investors with assets of less than £50m.[288]

8.14 Our online survey found that 91% of investors have not switched consultants in the last five years. Institutional investors told us that the direct costs associated with switching were not prohibitive, but that the time and resource needed for a tender process is a deterrent. Those that did switch said they found it easy to do. In cases where institutional investors considered switching, but did not, the main reason given was they could not find a good alternative provider.[289]

8.15 Although switching rates are low we did find some evidence of investors using more than one adviser, although this was only for clients with large levels of assets. A number of larger institutional investors told us they use a panel of consultants, taking advice from several advisers before making a decision, or get specialised advice on particular topics. This was backed up by our institutional survey results which found almost a quarter of investors who bought services from investment consultants used more than one.

Key trends

8.16 Pension schemes are key clients for investment consultants. In the UK, pension trustees are required to obtain and consider 'proper advice'[290] as to whether an investment is satisfactory. For existing investments, trustees should obtain advice periodically.[291] Trustees usually fulfil this requirement by getting advice from investment consultants, although some larger schemes will have this expertise in-house.

8.17 In 2015, 93% of investment consultant advisory[292] revenues came from pension schemes, with the vast majority of this from DB[293] schemes. Changes in the pensions markets are therefore an important factor in understanding the sector and the commercial environment consultants operate in.

8.18 Pension Protection Fund data shows that the number of DB pension schemes has been in decline over the last five years.[294]

287 20% of respondents said two to three investment consultants could, and 40% said more than three could.

288 When we split this by investor size, we found that a larger proportion of smaller investors (those with assets of less than £50mn) said only one consultant could meet their requirements (60%). The reverse was true for larger investors (those with assets of more than £1bn), with only 11% mentioning this was the case. However, caution should be used when interpreting these figures, given the very small samples these are based on.

289 This was from a small base of 25 respondents.

290 Section 36(6) of the Pensions Act 1995. "Proper advice" means advice from someone authorised under FSMA to provide a regulated activity, or the advice: of a person who is reasonably believed by the trustees to be qualified by his ability in and practical experience of financial matters and to have the appropriate knowledge and experience of the management of the investments of trust schemes.

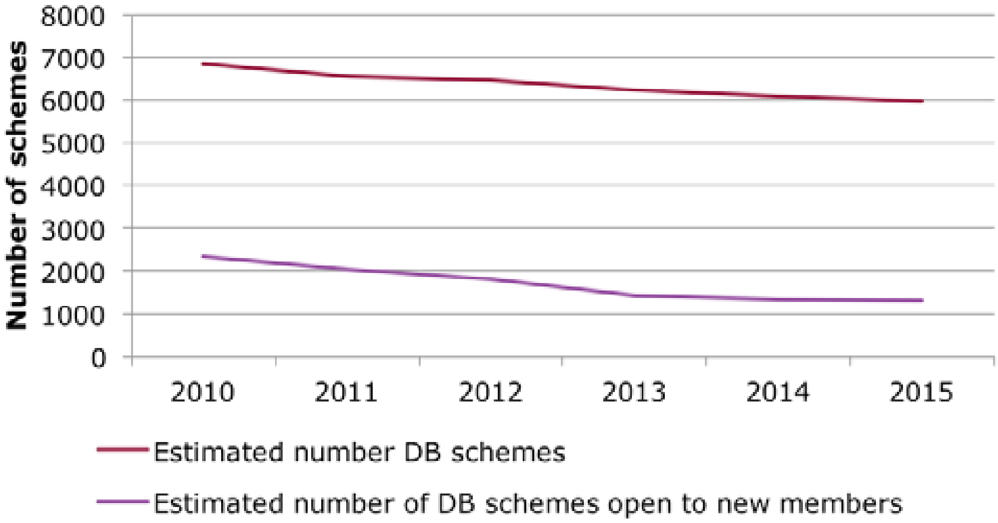
291 Section 35 Pensions Act 1995, says that trustees from time to time must revise a written statement of principles which govern investment decisions of the scheme and in doing so need to seek advice.
Regulation 2 (2a) *The Occupational Pension Schemes (Investment) Regulations 2005*, 'Before preparing or revising a statement of investment principles, the trustees of a trust scheme must – (a) obtain and consider the written advice of a person who is reasonably believed by the trustees to be qualified by his ability in and practical experience of financial matters and to have the appropriate knowledge and experience of the management of the investments of such schemes'

292 Advisory refers to revenues from investment consulting excluding fiduciary management

293 A trust-based pension scheme that provides benefits based on a formula involving how much a person is paid at retirement (or how much a person has been paid on average during their membership of the scheme) and the length of time they have been in the pension scheme.

294 The Pensions Regulator and Pension Protection Fund The Purple Book: DB pension universe risk profile (2015) www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/purple_book_2015.pdf

Figure 8.2 – Estimated number of DB schemes and estimated number of DB schemes open to new members



Source: The Purple Book

8.19 As DB schemes are a significant client group for investment consultants, these changes may put pressure on consultants' traditional business models in the long-term. However the decline in DB scheme numbers appears to have been offset by increased demand in the short-term for advice on more complicated areas such as de-risking driven by the environment of declining long-term interest rates.

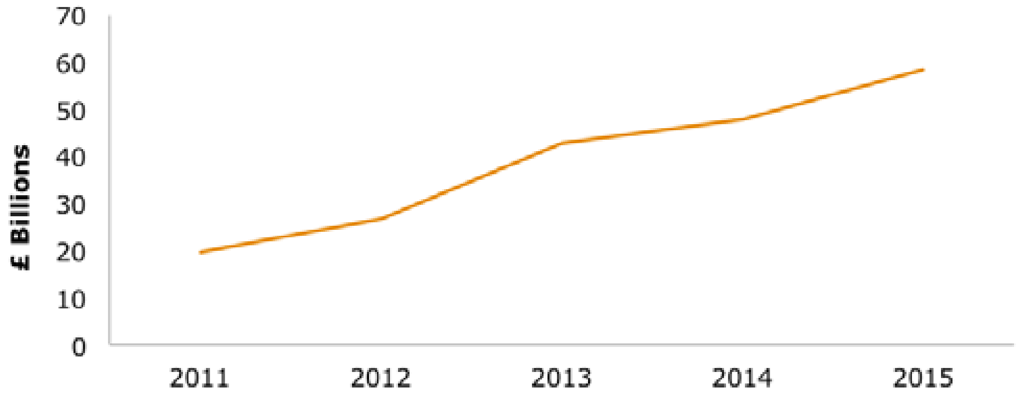
8.20 Another growth area for investment consultants' revenues has been from DC clients. While the revenue generated from DC clients is low compared to DB clients, it is increasing.

8.21 While there are more DC schemes than DB schemes, they tend to have much smaller pot sizes.[295] This may mean that DC schemes typically have less money available to spend on advice. Furthermore, the nature of DC investments where all risk lies with the investor rather than the pension scheme, means that DC clients require less advice on an ongoing basis than DB clients.

8.22 In recent years, potentially driven by these changes, investment consultants have expanded their business into new areas; one example of this is the move into fiduciary management. As indicated in the chart below, the total value of assets managed by investment consultants under a fiduciary arrangement has tripled in the last five years.

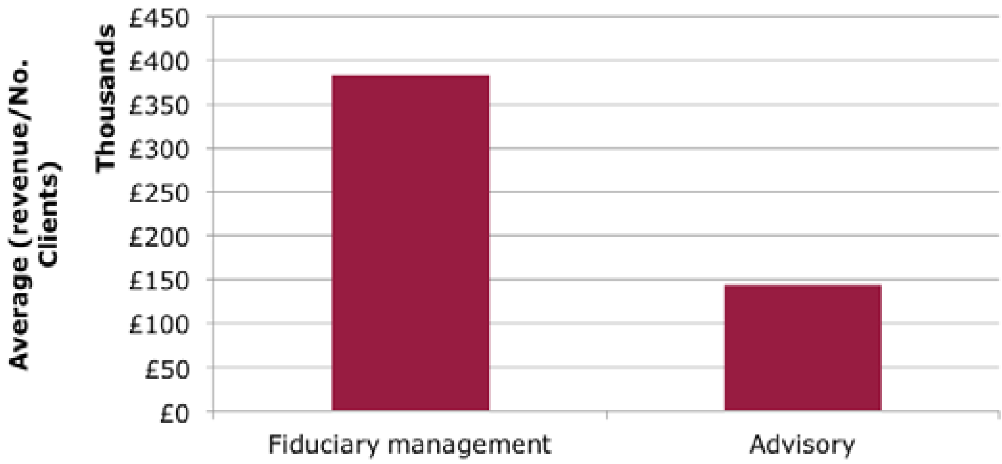
295 According to TPR data, the median asset value for DC trust schemes with under 12 members is around £746,000 and the mean asset value for DC trust schemes with over 12 members is around £20.333m

Figure 8.3 – Value of assets under fiduciary management provided by investment consultants[296]



8.23 Assets controlled by investment consultants under fiduciary management are relatively small compared to the level of assets they influence under advice. In our sample of firms, the assets under advice were approximately £1.6 trillion while the assets under management as part of fiduciary arrangements were £58 billion. However on a per client basis, fiduciary management generates much higher revenues than traditional advisory service.

Figure 8.4 – Average revenue per client from fiduciary management vs. advisory (2015)[297]



8.24 Of the investment consultants in our sample offering fiduciary management services, 41% of their combined advisory/fiduciary management revenues came from fiduciary management, despite representing just 4% of assets under advice.

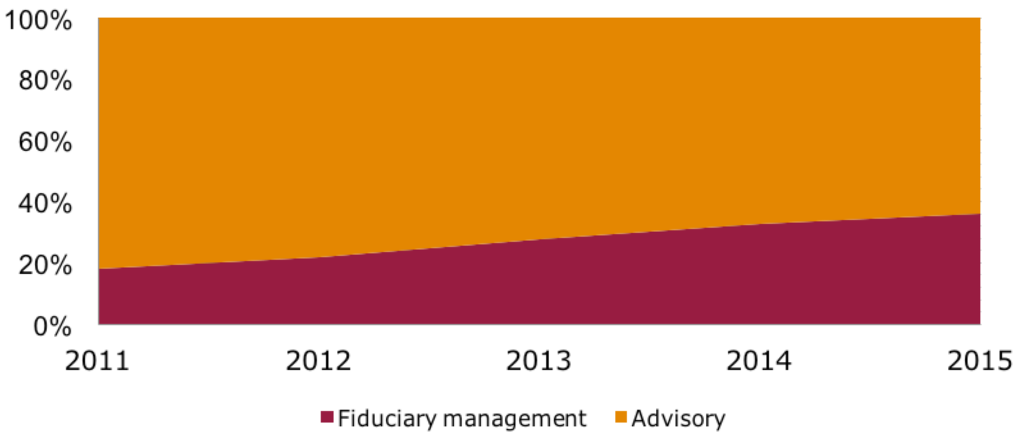
296 Total assets managed under fiduciary arrangement for investment consultants in our sample – data from firm submissions.

297 Revenue per client calculated for each firm which had clients for each business line in our sample and then a mean average was taken across the firms included. 7 firms included in fiduciary management calculation, 12 firms included in the advisory calculation.

8.25 For our sample of fiduciary managers we estimate that the average price charged to clients with assets under £50m[298] in 2015 was 30bps and ranged from 11bps to 49bps[299]. This compares to advisory services where an equivalent basis point average cost for clients with assets under £50m was 9bps and ranged from 5 to 15bps.

8.26 Fiduciary management therefore already has a significant impact on the revenue of investment consultants and market responses and growth trends suggest this will continue.

Figure 8.5 – Share of investment consultant revenue over time, for fiduciary management vs. advisory[300]



8.27 Six firms in our sample provided profit margin data.[301] Although there was significant variation between firms, on average we found that the operating margin was largely comparable between the two services: 27% for advisory and 25% for fiduciary management.[302]

8.28 Market participants suggested that fiduciary management is a scale business and margins could be expected to grow over time as scale is reached. Whether margins for fiduciary management settle at a level equivalent to or higher than traditional advisory, or whether competition brings these margins down, the growth of fiduciary management still provides a way for consultants to stop absolute profits from falling as the DB market shrinks. The changes to the market could therefore strengthen the incentives of investment consultants to use their trusted adviser status to upsell fiduciary management to their existing clients.

8.29 Fiduciary management arrangements are mainly for DB schemes but the growth of master trusts is also creating growth in the DC space. Master trusts involve a single provider managing

298 We have focused on clients with assets under £50m as this was the most common client size to use fiduciary management.

299 Based on the revenues and the number of clients with assets under £50m, submitted by a sample of six investment consultants. We have assumed that the average client asset level is £25m (the group mid—point).

300 Date based on aggregate revenue figures from providers in sample which offered fiduciary management.

301 One firm was excluded from the sample as indirect costs had not been allocated.

302 There was a lot of variation between firms' profit margins potentially caused by allocation issues which mean this result is unreliable. We have not concluded which business area (fiduciary management or advisory) is more profitable for consultants as we have not completed a full profitability assessment. 27% and 25% average margins are based on median values of a sample of five investment consultants which provided the FCA with profit data for 2015.

a pension scheme for multiple employers under a single trust arrangement. A number of consultants and EBCs now provide master trusts to DC clients.[303]

8.30 In addition to offering third party investment funds in their fiduciary management services, some investment consultants offer their own branded fund of funds, multi-asset funds or platforms. Here investment consultants can be directly competing with asset managers.

8.31 Finally, we have seen the emergence of a service where advisory firms help pension schemes select appropriate fiduciary managers. A number of firms now provide advice to institutional investors on the selecting, monitoring and implementing of fiduciary management solutions.

Fees and pricing

8.32 Investment consultants predominantly use one of two pricing models. They either use hourly rates where they charge for time spent and costs, or they use retainer fees, where they agree fixed fees with clients for regular, well-defined services.

8.33 Pricing starts from a standardised fee card but consultants may give discounts to win business or where they have a wider relationship with the client (for example, if the client buys other services from them) or to keep the clients.

8.34 Typically consultants charge an ad valorem fee for their fiduciary management services, although this is not always the case. They may also charge a performance fee.

8.35 When setting prices for both investment consultancy and fiduciary management services consultants consider a range of factors including the size and complexity of the scheme, the trustees' views on the level of risk they want to take and the timescale over which they want to meet their scheme's funding objective.

8.36 Some of the smaller investment consultants have introduced more innovative pricing models. For example, some consultants offer manager selection for whole of market to clients for free. The successful manager then pays the consultant. In some cases, the manager may pass this cost on to the client. We discuss the implications of this 'pay to play' model later on in this chapter.

How does advice given by investment consultants affect competition for asset management?

8.37 In this section we examine the influence of investment consultants on the investment decisions made by institutional investors and how that affects competition between asset managers.

Investment consultants' advice and recommendations influence institutional investor choice of investment strategies

8.38 Investment consultants advise on investment strategy and asset allocation. They help institutional investors think about the mix of asset categories (such as stocks, bonds, and cash) and strategies (such as passive or active management) that will help investors achieve their investment objectives in line with their risk tolerance and over a certain time period. If the advice given to every client is not tailored to their needs, the advice may not be appropriate and may not achieve their investment objectives.

303 In a master trust, the trustees of the scheme are professionals who are usually employed by the provider. This means that employers under this arrangement are not required to set up their own trustee boards, and investment decision-making does not need to take place at employer level.

8.39 Asset allocation is one of the most important elements of an investors' investment strategy that can impact returns over time.

8.40 If an investment strategy recommended by a consultant becomes popular with institutional investors, demand for that asset class and strategy is likely to increase, and its popularity may push more asset managers to start offering that product. For example, the uptake in LDI strategies has coincided with most consultants recommending that DB schemes have some sort of LDI strategies in place. Where this asset class suits the investors' needs this is a good thing. It signals to asset managers what institutional investors want and, if there is a gap in the market, asset managers have an opportunity to win clients by offering it.

8.41 Investment consultants told us they formulate an investment strategy for a client after a detailed process, during which they work with the client to understand their investment beliefs, objectives and goals. On the other hand, we heard concerns from institutional investors and asset managers that not all consultants offer bespoke advice developed for individual clients. Instead smaller institutional investors, particularly the smaller pension schemes, risk getting the same advice that is given to multiple clients and is not tailored to their needs. Consultants are incentivised to do this because it allows them to spread the cost of researching and developing advice across a wider client base.

8.42 If the advice given by consultants is not driven by factors that can genuinely add value to an investors' portfolio, asset managers may be encouraged to develop products that serve consultants rather than investors' needs. For example, asset managers may develop products that are too complex for some investors.

8.43 Through our qualitative research we have heard that institutional investors, such as trustees of pension funds, tend to focus more heavily on the manager selection than on setting the asset allocation. This may partly be because investors find it difficult to engage with and challenge their consultant on this latter aspect of their advice. We discuss this later on in this chapter.

Consultants' due diligence for asset managers may reduce operational risk for clients but their ratings are not a good predictor of performance, despite these ratings driving fund flows

8.44 We performed an econometric analysis to understand the effect of consultants' recommendations (defined as products receiving high ratings) on net flows in to and out of funds. We found that changes in investment consultants' recommendations in our sample have a large and statistically significant effect on net flows into institutional investment products.[304] We also found that net flows respond quickly to consultant recommendations, and this response carries on for a substantial period.

8.45 This finding is consistent with responses to our questionnaires to asset managers, discussions with institutional investors, and consultants' financial data showing the revenues relating to the sale of advisory services to investors. For example, when analysing annual net flows we found that an additional recommendation from one of the consultants in our sample led to an increase in assets of $460m in the following year (an increase of 53%). When examining quarterly net flows we found that institutional investors are quick to respond to changes in recommendations. For example, an additional recommendation from one of the consultants in our sample led to $185m in additional assets in the following quarter (an increase of 19%).

304 This was after controlling for other potential explanatory variables such as past performance, performance rankings against other products in the same category, excess performance, excess performance rankings against other products in the same category, total net assets, and fees at the end of the sample

8.46 When looking at the performance of investment products recommended by investment consultants our analysis shows that, across all product categories taken together, consultant recommended products do not perform better than non-recommended products. However, we found that both consultant-recommended and non-recommended products outperformed their benchmarks on a gross basis by between 80 and 100 basis points annually on average. We found that this gross outperformance was eliminated by asset manager charges.

8.47 The finding that on a gross basis both recommended and non-recommended products outperform their benchmarks requires further investigation as it suggests that on average institutional products outperformed their manager-specified benchmarks. This could reflect genuine outperformance by institutional products, in which case other investors must collectively have been underperforming. Please see Annex 6 for a further discussion of these results.

8.48 As discussed in Chapter 4, institutional investors find it difficult to identify good quality asset managers, given that observable fund performance is an outcome of a range of factors, not just the investment skill of the manager. This also makes it difficult for skilled fund managers to signal their quality. As a result, many institutional investors are relying on their investment consultants to identify skilled managers.

8.49 Bearing in mind the significant impact that consultants' ratings have on flows, we examined the criteria that consultants use to evaluate asset managers. While all consultants rate and rank managers differently, the rating processes and factors they consider have similarities. One asset manager informally described this to us as an assessment of 'people, process and performance', which appears to broadly apply across investment consultants.

8.50 The rating process begins with consultants considering the 'full universe' of managers and funds available. The starting point for almost all consultants is databases such as Morningstar, eVestment, Bloomberg, Hedgefund.net, Prequin or their own proprietary database if they have one. Consultants told us they also rely on their experience of the sector and 'general market knowledge'. A few said they may be approached by managers who want to be rated or they may approach managers to develop products they believe their clients will interested in.

8.51 The consultants we spoke to said they try to be as comprehensive as possible when identifying the initial 'universe' of managers and products, and that they review databases frequently. One consultant with its own proprietary database said they track information on more than 9,200 managers and over 30,000 funds, while another said that they have information on 7,800 managers and more than 38,860 products.

8.52 When asked whether they were open to researching a strategy, manager or product if requested by a client, almost all consultants said that while these requests were rare, they would generally comply with clients' requests to research a manager. There may be instances where the consultant will refuse for genuine reasons, for example, if the consultant does not have the adequate expertise in that asset class. Only one consultant told us it has a policy not to evaluate strategies if requested by a client.

8.53 After an asset manager has been included in the consultant's universe of funds, the manager or strategy is assigned a rating. The terminology of the rating systems varies. Some consultants produce ratings such as Buy, Qualified, Sell; others assign letters, others numbers. Generally a product is placed within one of three to four categories. The lowest category indicates that the product and manager meet a minimum quality threshold, whereas highly rated products are those which consultants recommend to their clients.

8.54 We found that around 7% of the strategies were rated highly by at least one of the six investment consultants in our sample (out of a population of around 30,000 strategies). Interestingly, it appears that at any given time there is little consensus among investment consultants – we found that only 1.1% of strategies were highly rated by two or more.[305] However, over longer time periods we found that there is substantial overlap in the highly rated strategies of consultants.

8.55 The range of factors consultants consider when rating a manager or strategy can be broadly categorised into quantitative factors, such as measurable metrics including historical performance and fee levels; and 'softer' qualitative factors. These qualitative factors include:

- **Quality and stability of fund managers and their team.** They consider the experience, talent and stability of the investment team, the tenure of the fund manager with a strategy, the asset management firm's culture, the firm's incentives and compensation policies to help retain people.

- **The investment style of the manager.** This can include an assessment of the reasonableness and clarity of the manager's investment philosophy and objectives, whether the strategy/product is managed in line with the stated investment process, whether risk controls seem adequate, or even an assessment of the 'level of aggressiveness' in terms of the use of derivatives or leverage.

- **Ability of the manager to generate new and innovative ideas.** This includes a consideration of whether there is a 'competitive advantage' in the way a team generates investment ideas, and whether the fund manager has the resources, skill set and scale to exploit opportunities effectively.

8.56 While past performance is considered as a factor, consultants generally said this has limitations. A few explicitly said that past performance was not indicative of future performance. Based on a combination of the qualitative and quantitative factors above, the consultant will determine a rating for the manager.

8.57 A couple of asset managers suggested that consultants place more emphasis on soft factors in the rating process than on managers' past performance and fees, and this is also consistent with the information consultants gave us as well. The larger consultants told us softer, qualitative factors such as investment staff and investment process are the most important deciders of future performance and that they believed a 'positive assessment of the first two tends to be highly correlated with a positive outcome for performance'.

8.58 Consultants may emphasise the evaluation of soft factors because this is where they can differentiate their manager research and selection service from competing consultants. This is particularly relevant if consultants market their ability to get 'face time' with an asset manager or the time they spend conducting regular on-site visits with investment teams.

8.59 It is important to note the benefits that clients can get out of this rating process. The due diligence done on the asset manager's business and systems and controls can reduce operational risk for the investor. It can reduce search costs and help investors streamline their selection process. Consultants' research on the universe of managers means that investors have a wider pool of managers to choose from, many of whom they may not have been aware of otherwise. Asset managers who get good ratings benefit too because they can access a wider pool of clients,

305 eVestment and information provided by our sample of investment consultants.

although it may also create a barrier to expansion for fund managers who are not highly rated. We discuss this further below.

8.60 However, the intention of the manager selection process is not to find managers who meet minimum standards. By ranking managers, consultants are indicating that in their view some managers are likely to do better than their peers for that asset class.

8.61 Based on our analysis, on average investment consultants are not able to identify managers that outperform compared to non-highly rated managers.

Investment consultants do not appear to drive asset managers to compete on fees

8.62 Investment consultants told us they consider asset manager fees at three different points: during the rating of a manager or a strategy; at the time of appointment; or periodically after the manager has been appointed by a client. While consultants appear to recognise that fees are important, their emphasis appears to be on making sure that managers' fees are in line with the market rather than driving fees down. When benchmarking fees, the general approach appears to be to make sure that the fees are 'broadly typical' for the market.

8.63 Overall, we found that there is not a strong emphasis on fees in the consultants' rating process. For example, one consultant explained that fees only made up 5% of the final score[306] When discussing the rating process, only one consultant acknowledged upfront that in some asset classes actively managed funds do not, after fees and in aggregate, add value for investors and keeping costs to a minimum is important to increasing their clients' chances of outperforming the index.

8.64 Consultants told us that when putting together a shortlist for a client, they consider the managers' fee levels and how they compare to similar funds or strategies. Very expensive outliers are removed. This encourages managers to set prices within an 'acceptable price range', because managers do not want their fees to be too high, or too low.

8.65 Most of the consultants we spoke to said they offer to negotiate discounts for their clients, irrespective of size, during the manager appointment process. There is not a standard approach used by all consultants to negotiate and review fees and approaches may also vary from client to client within the same consultancy. Where the client has an in-house investment team, the consultant may only act as a sounding board. Consultants told us that there is little scope to negotiate on fees for pooled funds (which is where smaller clients will be invested), compared to 'bespoke' segregated mandates.

8.66 The larger consultancies in particular said they made a significant effort to monitor fee levels across the market and valued their ability to negotiate discounts for clients. However, the success of larger consultancies in negotiating discounts for some clients may in part be due to the size of the client. There is an emphasis on negotiating fees for clients with a larger amount of assets, who may have been able to receive scale discounts from managers anyway. The ability of smaller clients to receive discounts, with or without the benefit of a consultant's assistance appears to be limited. Some consultants said that they attempt to aggregate clients' assets where possible to take advantage of scale.

8.67 Consultants told us they also help clients with ongoing monitoring of asset management fees by keeping abreast of developments in the sector and comparing against fee surveys. However it may be that not all investors receive this service. We even heard an example from a pension's

306 The respondent did say this rating process was often adjusted and it was not unusual for the fund appraisal to undergo robust challenge and for scores to be adjusted. This is cited here as an example of some market practices.

expert of a consultant who was unable to identify cost elements for their client leading to misreporting going undiscovered.[307]

8.68 Apart from helping some clients secure economies of scale, we found that consultants may add value by identifying opportunities which investors were unaware of. For example, where a manager looking for initial capital to start a fund is willing to offer lower rates to early investors. Here consultants are able to offer a service that an investor may not be able to identify themselves.

8.69 A number of investment consultants have been critical of the ad valorem fee structure used by asset managers. In their view it does not allow clients to benefit from economies of scale and incentivises managers to focus on increasing assets under management, as that is directly proportional to the fees they can charge. Despite this critique, consultants have not been able to use their influence on managers to move away from ad valorem fees. In fact consultants acting as fiduciary managers typically use ad valorem charging in their own fiduciary management arrangements as well.

Consultants' ratings can act as a barrier to entry, expansion and innovation

8.70 All the asset managers we spoke to emphasised the importance of consultants as a gateway to institutional clients and that being highly rated by consultants is an important way to attract clients. The importance of investment consultants as a gateway to the market can be seen by the large proportion of asset managers' institutional marketing budget which is spent on building relationships with investment consultants. This includes spending on things like sponsored events and conferences.

8.71 Investment consultants can also help asset managers gain access to institutional clients without them having to market to all institutional investors. They can provide new funds and managers with a route to market, and if consultants rate a manager or fund highly it can lead to significant fund flows.

8.72 In some instances the rating systems used by investment consultants can create barriers to entry, expansion and innovation for asset managers. We heard from some managers that it can be difficult for them to get rated by an investment consultant. Although it is relatively easy for them to submit their data into a consultant database, which increases their likelihood of being rated, it is more difficult to move from a database entry to meeting the consultant and getting recognised and noticed. In some cases asset managers are expected to have a three-year track record in order to be rated, which can be a barrier to entry for new asset managers. This feeds into the emphasis on past performance and the creation of multiple strategies by asset managers so that some of them will have good three-year track records which can be marketed.

8.73 Asset managers told us they were concerned that because consultants have a finite research budget, they have become much more selective about the managers they research. For example, consultants may focus on larger managers who can be recommended to a larger proportion of their client base, because these managers have sufficient scale to absorb large amounts of assets. This puts asset managers with capacity constraints or those that offer more niche products at a disadvantage. We also heard that it can be difficult for managers to get on a consultant's buy-list if the consultant already has many managers operating in that asset class. This prevents new managers in that asset class from competing effectively, even if they have an innovative or superior product.

8.74 We heard mixed views from institutional investors on the influence consultants' recommendations have on their choice of asset manager. Respondents to our online survey said that when selecting a manager, a consultant's recommendations were not as important as other factors,

307 See Tilba, Baddeley & Liao (2016) published alongside this report

such as management and other fees, the reputation of the manager, past performance, the range of funds available, and whether the asset manager specialises in the sector they want to invest in. However, in the academic work we commissioned[308] our academic work and one-to-one conversations with institutional investors, the role and influence of investment consultant recommendations when selecting fund managers was a particularly important factor behind the eventual choice. This was confirmed by our fund flow analysis. Many institutional investors we spoke to suggested that they would be reluctant to go against their consultant's advice, although this was less of a concern for the larger investors.

8.75 A few asset managers also raised concerns about the transparency of the way consultants arrive at their ratings. Often an asset manager will not know if they are about to be downgraded. Some suggested that a feedback mechanism would be helpful in allowing them to improve their offering and service and address the concerns resulting in the downgrade if possible.

8.76 Finally, we heard that as investment consultants are offering both fiduciary management services and fund of funds products, this can present an opportunity for asset managers to participate in the management of these products (although typically only where they are highly rated). However, some asset managers felt that this presented a conflict of interest, whereby the asset manager was required to share all of the details of their products with the investment consultant in order to receive a rating, but the investment consultant could take the ideas generated by the asset managers and use them to develop their own product. They felt that this reduced their incentive to innovate.

8.77 From a client perspective, institutional investors told us that they do not generally ask for consultants to rate managers that are not included in the consultant's universe of managers and strategies. One investor gave us an example of requesting that a consultant research a specific fund manager that was not rated, and the cost of this fell to the client. This creates a deterrent for investors to consider unrated managers.

8.78 A few consultants have introduced a 'pay to play' model, where consultants ask asset managers who are awarded the mandate to pay the consultant rather than the client, for research and associated costs incurred as part of a tender process. The few institutional investors we spoke to were generally positive about this model. An asset manager told us it did not disadvantage them because the process is transparent and potential cost are communicated to managers at the start of the process, either in absolute amounts or as a percentage of assets the client invests with the selected fund manager.

8.79 The 'pay to play' model can create barriers for new or small asset management firms who may not be able to pay to participate in these types of tender processes. It may also result in reduced choice for investors if asset managers do not participate in the manager selection exercise because of this model. Some asset managers do not want to participate in tender exercises run like this because they do not want to 'pay for business' while others said they would not put their most popular funds forward because they do not need to pay for clients. If the asset manager indirectly incorporates the consultancy costs into the AMC, it would also result in higher fees for investors. Given that only a small number of consultancies operate on a 'pay to play' model, the approach does not appear to be singularly distorting competition for small asset managers. However it contributes to the difficulties that smaller asset managers may face.

8.80 Investment consultants can both drive and hinder innovation in the asset management market. Through their close relationships with their clients and by understanding their client's needs they can identify opportunities for product development which they can pass on to asset

308 See Tilba, Baddeley & Liao (2016) published alongside this report

managers or work with them to develop. However, some asset managers have argued that they may also create barriers to innovation, including:

- Asset managers told us that the manager ratings are often reactive. This can mean innovative or market responsive products are only adopted slowly, creating a barrier both to new ideas from market participants and to innovation by asset managers.
- Some asset managers told us that they were concerned about sharing their new innovative investment strategies or products with investment consultants in case consultants use them in their own in-house asset management offerings, including multi-manager products or fiduciary manager offerings.

How are conflicts within the business model of investment consultants managed?

8.81 In this section we discuss how conflicts of interest and misaligned incentives may arise in investment consultancy, the incentives which drive investment consultant behaviour and how consultants manage these conflicts. We also examine how trustees approach these conflicts of interests.

8.82 The conflicts of interests we considered as part of our market study include whether:

- Investment consultants have an incentive to give favourable ratings and/or allocate client assets to asset managers where there is a beneficial arrangement between the asset manager and investment consultant.
- Investment consultants have an incentive to positively evaluate managers and strategies they have recommended. Investment consultants have an incentive to recommend strategies of asset managers where a wider business relationship exists between the two groups.

8.83 We also considered whether the structure and features of the market also give rise to and promote misaligned incentives:

- Investment consultants have an incentive to over-recommend complex investment strategies or generate churn which requires greater work for themselves in order to generate additional revenue.
- Investment consultants have an incentive to advise clients to use their own fiduciary management services where a client would be better served under an advisory model or with another provider; or recommend that clients use their own in-house asset management products rather than those provided by external asset managers.

8.84 Conflicts of interests, such as consultants having an incentive to give a positive evaluation to managers they recommend, create concerns that need to be monitored and managed. However, some behaviour such as recommending their own in-house fiduciary management services is not necessarily problematic. Consultancy firms have a legitimate commercial incentive to promote more products and generate greater revenue. However, the nature of the products involved here creates concerns about this type of upselling. In order to sell one product, such as fiduciary management, consultants may be compromising the quality of the ‘first’ product, in this case advice. This is aggravated by the inability of clients to assess the quality of advice they receive, which we discuss in the next section.

There is a strong culture of gifts and hospitality in the investment consultancy sector which could influence the ratings given to managers

8.85 We found that while investment consultants typically have policies banning the acceptance of monetary rewards, the level of non-monetary benefits that a consultancy firm can receive varies considerably from firm to firm. Earlier this year, we published findings from a thematic review about benefits provided and received by firms conducting MiFID business, and those carrying out regulated activities for retail investment products. One of the findings was that hospitality given or received such as attending or participating in sporting or social events (e.g. golf, tennis, concerts) did not appear capable of enhancing the quality of service to clients. The review concluded that these types of events were either not conducive to business discussions or the discussions could better take place without these activities. Moreover, the cost of these events is ultimately borne by the end investors.[309]

8.86 It is not clear what benefits the culture of accepting gifts and hospitality in the investment consultancy sector brings to end-investors. This culture appears to introduce an unnecessary conflict of interest that has the potential to affect the independence of investment consultants' ratings of asset managers. Although the investment consultants examined as part of this market study[310] were able to demonstrate policies which they used to mitigate this conflict, the benefit to end-investors of consultants accepting such hospitality events is unclear. For example, accepting tickets from asset managers to attend concerts or spring events seems unlikely to result in benefit to end-investors.

8.87 Because of the potential for harm identified above, we investigated the magnitude of gifts and hospitality acceptance by investment consultants over time.

8.88 We found, from our sample of firms, that the level of gifts and hospitality provided by asset management firms and groups and accepted by consultants has fallen substantially since 2013; this coincides with the publication of our inducement guidance in early 2014.[311]

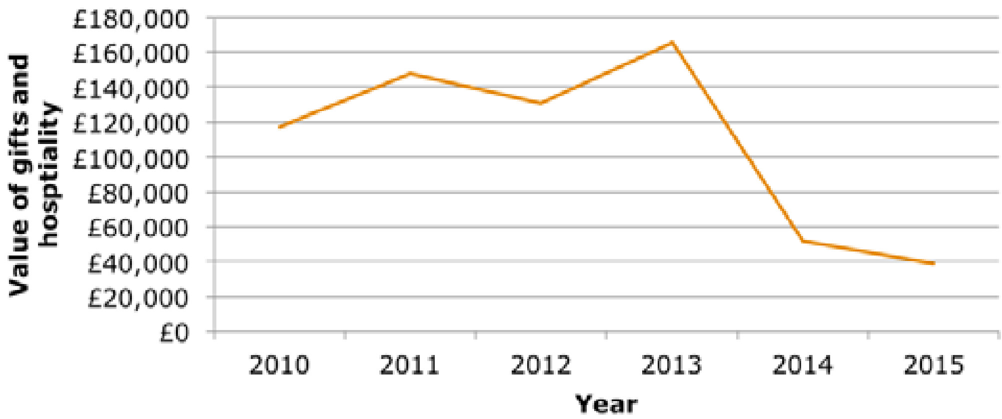
8.89 However a number of investment consultants still continued to accept hospitality in 2015 including attending sporting and cultural events at the expense of investment management firms. Following the publication of our thematic review earlier this year which confirmed our expectations about providing these types of hospitality events, the levels of hospitality may reduce further.

309 See FCA Inducements and conflicts of interest thematic review: key findings (2016) www.fca.org.uk/news/inducements-conflicts-interest-thematic-review-key-findings

310 Sample of six investment consultants assessed for which the FCA received data on gifts and hospitality, conflicts policies and historic ratings data.

311 www.fca.org.uk/news/press-releases/fca-publishes-finalised-guidance-inducements-product-providers-and-advisory

Figure 8.6 – Total value of gifts and hospitality accepted from asset management firms by our sample of 6 investment consultants



8.90 We have investigated whether investment consultants' past advice and manager recommendations may have been influenced by their acceptance of gifts and hospitality from asset managers.[312]

8.91 As part of our information request to consultants we asked for consultants' policies on gifts and hospitality, and the logs of the gifts and hospitality they have received in the past. We combined this information with data on the number of highly rated strategies asset management groups had received from the consultants during the same period, and examined whether there was any relationship between the two.

8.92 We examined the correlation between ratings and gifts and hospitality as an initial exercise. We found that for the consultants who accepted gifts and hospitality in 2015 there was a statistically significant positive relationship between the number of high ratings given to an asset manager and the number of gifts and hospitality items recorded in a year. This relationship could be explained by many factors, for example investment consultants may be more likely to accept hospitality if they are already considering rating one of the asset managers' strategies or have already rated the firm's strategies in the past and so have an existing relationship. At this stage we cannot rule out the possibility that consultants may have been influenced by their acceptance of gifts and hospitality, and we intend to examine this area more fully after we have published this interim report.

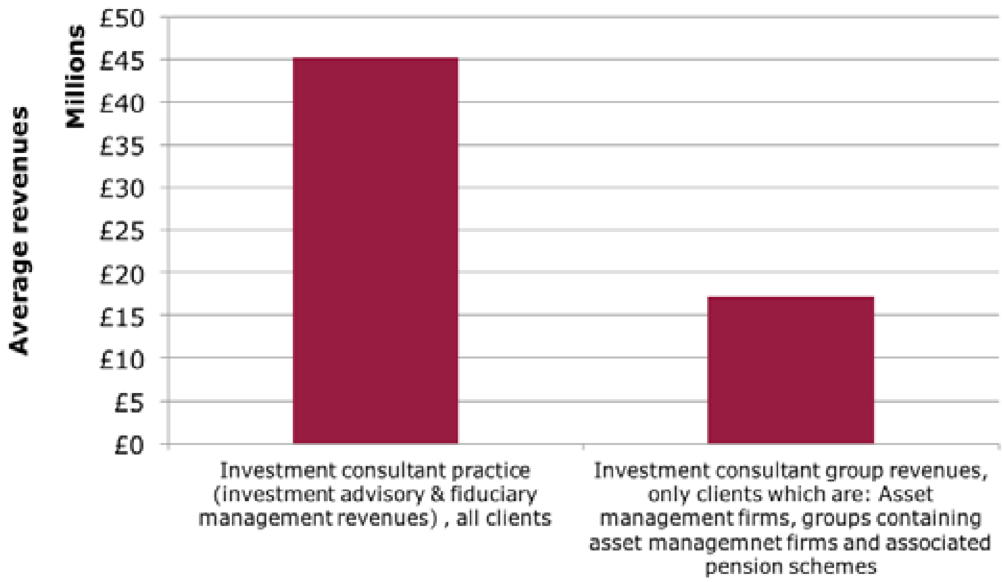
8.93 As part of this analysis, we also investigated whether the wider business relationships that exist between asset managers and consultants may have influenced the past ratings given by consultants. Asset managers, corporate groups containing asset managers and their pension schemes regularly purchase services from consultants such as the organising and hosting of investment conferences, data and consulting services covering areas such as retirement and HR, as well as direct investment consulting services.

8.94 These clients generate a lot of revenue for consultants – for our sample of consultancies the group revenues from asset management clients averaged £17m in 2015. To put this in perspective, consultants in our sample earned on average £45m[313] from their investment advisory businesses in the same period. This suggests that these revenues are significant to the investment consultants' business models.

312 As part of our information request to consultants we asked for consultants' policies on gifts and entertainment and logs of the gifts they have received over the past 5-10 years. We matched this information to data showing the number of strategies asset managers had highly rated during the same year and looked to see if there was any relationship between the two.

313 The figure of £45m contains some of the revenues from asset management clients but not all as other investment consultant business lines outside of the direct investment advisory business have also been included in the asset management client figure.

Figure 8.7 – 2015 – Average investment consultant group revenues from asset managers, groups containing asset managers and associated pension schemes compared with average investment consultant practice revenues [314]



8.95 When we looked at the group purchasing the most services from each consultant in 2015 we found that these asset managers did not always receive ratings from the consultant providing the services. However, a greater proportion of those purchasing services from asset managers received high ratings when compared to their peers who did not purchase these services.

8.96 Examining this in more detail by looking at correlations between the two variables we found that there is a positive statistically significant relationship between the two and that this is not fully explained by the size of the investment management group. As with the gifts and hospitality receipts, this relationship could be explained by a number of factors and at this stage we cannot rule out the possibility that consultants may have been influenced by their wider business relationships. We intend to examine this area more fully after we have published this interim report.

8.97 In response to concerns raised with us, we also assessed whether there were opportunities for consultants to give managers with whom they have wider business and commercial relationships preferential access to their book of clients. This could be through the seminars they organise or the training they provide to clients. To understand whether the training provided by consultants was in some way skewed or biased towards certain strategies or managers, we requested a sample of their training materials. In reviewing this information, we found there was no indication that consultants were attempting to sell more of their own services or promoting a particular asset manager.[315]

There was no evidence consultants are favourably evaluating managers they have recommended although poor performance can be disguised

8.98 As part of the ongoing services provided to clients, investment consultants also monitor and report on the performance of asset managers. We found that when reporting on the

314 Based on average revenues for sample of six investment consultants.

315 We did not set out to assess whether the training provided was appropriate or adequate and it would not be possible to make that conclusion by looking only at training materials.

performance of managers to whom consultants have given high ratings, there are instances where reporting, while not incorrect, is presented in a way that poor performance is difficult to identify or may not be sufficiently transparent.

8.99 In general, consultants tend to have standard items agreed with the client that they report on each quarter, which may make it difficult for investment consultants to disguise poor performance of their highly rated managers. However, we found that the quality and standard of information provided by consultants to trustees when monitoring investment performance was variable. For larger pension schemes that are likely to work closely with consultants, the information was clearer, more comprehensive and targeted. For smaller schemes and investors with less expertise, the information presented was at times difficult to understand and important factors were not always highlighted. This could lead to poor performance not being communicated or being easily disguised.

8.100 The incentive for consultants to under-report poor performance is likely to be stronger for their fiduciary management products. One institutional investor we spoke to said that they had used a fiduciary management arrangement and found that the reporting was misleading for each of the metrics monitored. As a result, they no longer use this arrangement. We discuss the difficulty in monitoring fiduciary management arrangements later on in the chapter.

Consultants may be incentivised to over recommend complex investment strategies to clients and it is hard for clients to assess whether this is necessary

8.101 The business model of consultants, in particular their hourly rate charging structure, creates incentives for them to recommend complex investment strategies to clients. Clients in more complex investment strategies require more time spent on researching strategies, running manager selection exercises, undertaking trustee training and eventually more ongoing monitoring – all of which justifies higher fees for consultants. If consultants recommend churn in their clients' portfolios they have to undertake research on new managers and run tender processes. Where the consultant offers transition management services, this creates revenue for that business area as well.

8.102 Institutional investors and pension schemes in particular appear to be adopting increasingly complex investment strategies. For example, we have seen an increase in the number of DB schemes that have adopted LDI strategies.[316] The total UK pension scheme exposure to LDI was £741 billion in 2015, up from £658bn in 2014. There were 256 new mandates in 2015, bringing the total to 1,287 LDI mandates in the UK.[317]

8.103 The number of institutional investors using hedge fund products has also increased. Some institutional investors told us that in their view some hedge funds can be unclear about the assets in which they are invested. Some hedge funds may also invest in very esoteric asset classes, although most pension funds will not typically invest in those types of hedge funds. If they do, trustees would typically ask their consultants to carry out similar, or even tougher, due diligence on the hedge funds as they do on the traditional asset managers.

8.104 Complexity can also come from the number of asset managers in a mandate. Having more managers requires more oversight and monitoring, and often investors will need help from the consultant to understand how the large number of managers fit together in the portfolio. Our online survey found that 47% of respondents use more than three managers and of the

316 The aim of liability driven investment strategies is to match returns to the time frame over which the liabilities arise (say 20 years), so as to make the fund less vulnerable to interest rate and inflation risks. Typically, LDIs use swaps and other derivatives to hedge against the risk of changes in the economic climate that might affect the value of their investments in the medium or long term.

317 KPMG *LDI Survey* (2016)

trustees of the pension schemes we spoke to some used more than 3 fund managers. They stated that this approach was used to diversify assets and manage the risk of poor performance.

8.105 For some smaller schemes, increasing complexity can be overwhelming. We heard that it may lead them to decide that they do not have the necessary resources or expertise, prompting them to consider fiduciary management arrangements that they otherwise would not have considered.

8.106 It is difficult to conclude whether these trends are driven by investment consultants leading their clients into complex strategies or whether it is driven by the wider economic environment. For example, we heard from some institutional investors and consultants that since the global financial crisis, some pension schemes decided to hedge their inflation and interest rate risk and adopted LDI strategies. We have also heard that, in the current low yield environment, asset managers are developing more complex solutions to identify growth markets and products that could generate higher returns.

8.107 The increasing complexity of investment strategies and the underlying advice is not necessarily problematic. However, the inability of institutional investors to assess, monitor and compare the advice provided by investment consultants means that investors cannot assess whether this complexity is appropriate for them or not. We discuss this later on in the chapter.

Consultants are incentivised to recommend their own products

8.108 We heard a persistent concern from asset managers and institutional investors that once an investment consultant has developed its own products offerings, it will only recommend its in-house propositions.

8.109 As mentioned before, consultancy firms as commercial entities have a legitimate incentive to promote their products and services to generate greater revenue. However concerns arise if clients are pushed into in-house products even though there are better investment products offered elsewhere or if clients do not know that the advice they get does not consider the whole of the market. It may also affect other services that consultants provide. For example, we heard that one consultant had reduced the universe of multi-asset funds they would consider once they had their own in-house proposition.

8.110 The most commonly raised concern was where consultants develop a fiduciary management proposition. One survey found that 58% of schemes currently select the fiduciary arm of their existing investment consultant or actuary[318] as their fiduciary management provider and 75% of new mandates were awarded without a fully competitive tender in 2014 with investment consultants continuing to provide the majority of mandates.[319] However some market participants we spoke to suggested this trend has started to change as the market matures.

8.111 Behavioural biases may also influence trustees' decision not to undertake a competitive tender. Trustees may have 'confirmation biases' (interpreting new evidence as confirming their existing choices) and are confident that their consultant will be the best provider for them. Others suggested that concern about de-stabilising the relationship with their current consultant can deter trustees from tendering.

318 Aon Hewitt *Fiduciary Management Survey* (2015) www.aon.com/unitedkingdom/retirement-investment/fiduciary-management/fiduciary-management-survey-2015.jsp

319 KPMG *Fiduciary Management Market Survey* 2015 home.kpmg.com/uk/en/home/insights/2015/12/fiduciary-management-market-survey-2015.html

8.112 We also recognise that there may be instances where trustees are simply unable to undertake a competitive tender. One investment consultant we spoke to highlighted that running a tender process could be prohibitively expensive for schemes with limited resources.

8.113 Even if trustees undertake a tender exercise, we heard concerns about the transparency and independence of the process if the existing consultant was involved. One consultant told us that when they set up their fiduciary management business, the fund management mandates won came almost exclusively from their existing client base.

8.114 We heard concerns that consultants exploit these conflicts without the client fully understanding the implications. Trustees may incrementally delegate more and more of the decision-making process to their consultant and unknowingly end up in a 'fiduciary solution', without ever consciously having made the decision to do so. As a result they never considered alternative providers, for example by running a tender process, or fully considered the associated conflicts of interest from having their consultant as their fiduciary manager. One asset manager suggested that there should be steps in this process to signal to the client that this is the route they are going down. Alternatively, it may be that the consultant has constructed a product that is genuinely best in class or there may not be many other alternative products available.

8.115 In some cases fiduciary management can work well. Smaller clients in particular (such as smaller pension schemes) are attracted to this kind of investment solution. It allows them to employ more complex strategies and gives them access to products they could not access otherwise (e.g. alternative investments) without having to increase their scheme governance. Smaller clients are also able to benefit from scale, as the consultants can negotiate deals based on assets across their fiduciary management clients. Therefore, even taking account of the additional costs of fiduciary management it may be cheaper for some clients.

Investors are aware of consultants' incentives but that may not be enough to mitigate the risk

8.116 Larger investors we spoke to were aware that their investment consultants' interests may not always align with their own. Some of these investors had taken steps to use their consultants in different ways to get the best from them, such as using a panel of consultants rather than relying solely on one, using consultants only for specific projects or taking advice from several advisers before making a decision. However our survey suggests that this is likely to be a minority with 23% of respondents saying they used two or more consultants. We heard examples of pension scheme investment teams doing their own due diligence so that they could effectively challenge the consultants' views. This is likely to make it difficult for consultants to hide poor performance by their highly rated managers. However, smaller schemes are likely to have much less resource to do this or to pro-actively set the agenda and shape the form of performance reporting. As a result they may be much more reliant on investment consultants.

8.117 We conclude that investors are aware of consultants' conflicts but that may not be enough to mitigate the risk. The difficulty lies with the fact that it is hard for investors to assess whether the advice they receive is good, as we discuss in the next section. Most institutional investors we spoke to recognised that consultants try to sell other in-house products and services to clients. A few (mostly larger institutional investors) claimed that they would push back and in some cases switch consultant when they felt consultants introduced unnecessary complexity. However, as we set out in Annex 5, there is a variation in skills and expertise on trustee boards. Some trustees are not able to assess whether their consultant is managing conflicts well. This is exacerbated if trustees fail to challenge information they do not understand, which can be the case with trustees of smaller schemes.

8.118 The conflicts of interest that arise when investment consultants offer fiduciary management were recognised by almost all the investors we spoke to. Some institutional investors felt satisfied they were getting good outcomes from their fiduciary arrangement and potential conflicts were being well managed. But most felt that such conflicts could not be managed and as a result they avoided going into fiduciary arrangements with their investment consultant. It is important to note that our sample had a number of large, relatively sophisticated investors of which quite a few had some form of in-house investment expertise. Smaller schemes with less experienced trustees may not recognise the risks that arise here in the same way.

8.119 As mention earlier, fiduciary management arrangements are mainly in the DB space but are growing for DC schemes as well with the introduction of master trusts. Where consultants provide advice and consultancy services to DC schemes (as EBCs or advisers) they may have incentives to recommend that clients use their in-house master trusts. We heard that many employers do not have the incentive to expend a lot of resources on the selection and ongoing monitoring of DC schemes and so may go along with the consultant's advice without much scrutiny. This may mean that they do not choose the best or most suitable scheme; and if the scheme is not delivering the right outcomes for employees, the employer does not have much incentive to do anything about it.

Investment consultants are aware of the conflicts of interests that arise in their business model

8.120 As mentioned earlier, the advice provided by investment consultants on strategic asset allocation and manager selection can be provided in a way that is not regulated investment advice. Although where they undertake fiduciary management and offer investment management services, that part of their business is regulated. Investment consultancy firms, unlike other professional services such as accountants or lawyers, do not have statutory regulations governing their conduct nor do they have a professional body tasked with overseeing the sector.

8.121 We did a piece of supervisory work on how investment consulting firms are managing conflicts of interest when offering in-house fiduciary management services.[320] Investment consultants appear keen to acknowledge and demonstrate how they manage conflicts of interests that arise across their business model. In general investment consultants are forthcoming and transparent about potential conflicts and have management and disclosure policies in place.

8.122 Disclosure seems to be the primary approach that consultants rely on and peer review is the key control. Most consultants said that their status as a professional services firm was an indicator of adequate internal systems and controls to manage conflicts of interests that arise. Firms also frequently gave their professionalism, their culture, the competitive nature of the industry, and internal processes as key moderators of the risk that clients end up with unsuitable service. In their responses consultants told us that conflicts across all their business areas are managed through disclosure to clients, imposing Chinese walls between different business areas and making sure that staff do not overlap between conflicting business areas.

8.123 The consultants we spoke to were quite forthcoming in that the advice they gave to clients was not 'whole of market' – when approached by clients considering fiduciary management they would only advise clients on their in-house fiduciary service. Consultants told us they made this clear to their clients from the start. Conflicts of interests could lead to poor outcomes if advice and recommendations are not given in the best interest of end investors. These concerns become more acute if investors are unable to monitor and assess the advice they receive and switch if they are getting poor service. We discuss in the section below how institutional investors may

320 We held discussions with chief executives, heads of divisions and compliance staff. Our conclusions are based on these discussions with supporting evidence requested where applicable. Our work did not consist of any formal testing of compliance with procedures or auditing of a tender/appointment process.

find it hard to compare and assess the advice given and the complexity of mandates suggested by investment consultants.

Can clients monitor the services provided by investment consultants?

8.124 This section explores whether clients have the information and ability to monitor the quality of advice and fiduciary management services they get from investment consultants.

8.125 There are widespread concerns that a significant number of UK pension schemes are significantly underfunded relative to the value of the sponsor's business (or strength of covenant). According to one estimate, up to a 1,000 DB schemes are at 'serious' risk of falling into the Pension Protection Fund.[321] This underlines the importance of the advice consultants give to help trustees make the right investment decisions.

8.126 If clients cannot asses and monitor their investment consultant, they do not know if the service is appropriate for them and is adding value. Assessing consultants shifts away from analysing how well their advice has performed, to peripheral elements of their service or their marketing efforts. This can result in consultants competing on the tangible but less significant elements rather than on the important but difficult to measure element of their service.

It is difficult to evaluate investment consultants before appointing them

8.127 Institutional investors told us that a number of considerations factor into their decision when choosing an investment consultant:

- Personal relationships. A number of institutional investors stressed the importance of a good working relationship with the investment consultants. If this relationship is not working well or members of the consulting or client team change, this can trigger switching to another investment consultant.

- Reporting. The quality and clarity of investment consultant reporting, particularly their ability to communicate complex ideas concisely.

- Strong brand and track record. Investors told us that even though larger investment consultants are not always flexible at amending their style and services to meet investor needs, they are reluctant to switch to relatively smaller or 'unknown' consultants.

- Business relationships. In some cases, where the sponsor company[322] uses the consultant for other business purposes this can be influential. We were also told that if the employer has a good relationship with other service providers, for example, the actuary, this also is a factor they will consider.

8.128 The point missing from these considerations is any strong emphasis on investment consultants' performance. This may be because, as we found, there is limited information available to institutional investors on the quality or performance of advice when they are selecting a consultant.

321 This refers to private sector schemes. *The Greatest Good for the Greatest Number* The Pensions Institute (December 2015) www.pensions-institute.org/reports/GreatestGood.pdf

322 A sponsor company is usually a company or employer that sets up the pension scheme for the benefit of its employees and takes on responsibility of providing contribution payments if the scheme is not able to make payments.

8.129 Our review of a sample of marketing materials, including tender documents provided by consultants to prospective clients, found that the majority of marketing materials did not include specific information on the performance of the investment consultants' advice. Generic marketing materials often rely on qualitative feedback from clients on their experience of working with the consultant. Some consultants give examples of discounts secured from asset managers on behalf of their clients to demonstrate their 'value add'.

8.130 We found that more detailed information on the performance of consultants' advice is typically included in tender documents, called Requests for Proposal (RFP).[323] For example, when pitching to a prospective DB client, the consultant may include how other clients have seen improved funding levels as a result of the consultant's advice. The quality of information provided in the RFPs varied significantly from across consultants and there were variations across prospective clients. For larger clients, the information was detailed, relevant and clearly presented. This could be because larger clients are able to dedicate more resource to running the RFP process and are more prescriptive about the information they want and how they want it presented. We found that for smaller schemes, the information provided was often not clear and was difficult to understand.

8.131 The absence of a standardised market-wide methodology to assess the performance of an investment consultant means it is difficult for clients to know the accuracy of the performance information they get. For example, clients do not know whether the information is drawn only from a small sub-set of clients that performed well, or if there is survivorship bias in the sample. This information may therefore not be an objective assessment of performance.

Institutional investors find it difficult to monitor investment consultant advice on an ongoing basis

8.132 Our survey of institutional investors told us that 50% monitor the advice they receive from their investment consultant annually, 7% less than once every three years. Some mentioned that they use a regular tender process as an opportunity to evaluate the performance of their current investment consultant is performing.

8.133 Monitoring the advice given by investment consultants has two core elements. The first is the value added by the asset allocation advice given and the second is the performance of the managers recommended by the consultant. While consultants may attempt to measure the performance of their advice, we found that there is no standardised, comparable, industry-wide methodology for monitoring investment consultant advice, in particular for asset allocation advice. Even if investors try to calculate the value added by asset allocation advice, there is no consistent approach to allow them to make comparisons between consultants. There are differing views on what the appropriate benchmark for measuring asset allocation advice should be.

8.134 Most investment consultants told us that they monitor the quality of advice provided to clients and value added by the advice in some way. Consultants told us they use a variety of measures including comparing against other schemes of a similar size, absolute returns generated or progress against the investors' investment objective. Some consultants said they assess the value added by their advice by monitoring performance of the overall portfolio against client agreed benchmarks agreed with the client, such as the funding level progression[324] for DB schemes. However, while looking at overall portfolio performance is a useful measure of investment performance, it does not separate the value added by asset allocation advice from

323 An RFP is a document that a pension scheme (or other institutional investors) post to elicit bids as part of a tender process when interested in procuring a service.

324 The difference between the amount of money in a defined benefit scheme's funds, and the amount it needs to have in order to pay the promised retirement incomes to its members. The funding level progression refers to the progress made in filling that gap.

other factors, such as manager recommendations or general economic conditions. Without an appropriate point of comparison, the investor cannot determine if they could have done better elsewhere with another consultant or another asset allocation strategy.

8.135 Given the unique profile of individual schemes, it is often difficult to find a direct comparator. We found that there were a wide range of benchmarks used. Some consultants (or investors) compare the performance of the advice with returns made by clients of the investment consultant with similar characteristics; or compare returns against the wider universe of metrics published by other providers. The most referred to benchmark was the PPF 7800 Index, which tracks the latest estimated funding position for DB schemes. However, a trustee comparing against the PPF 7800 will only get a very general sense of how their scheme has performed against the aggregate position of other DB schemes. This aggregation is likely to be dominated by the assets and liabilities of the largest schemes. While this may give a general picture of how their scheme is performing, it is unlikely to provide any insight as to how far any change in funding level can be attributed to their consultant's advice. A consultant may suggest that a scheme advised by them is performing well compared to PPF 7800 index but that does not strip out the contribution of factors unrelated to the consultant's advice such as underlying employer contributions rather than the investment strategy the scheme followed.

8.136 We found that faced with the difficulties in monitoring asset allocation advice, consultants and investors mainly focus on monitoring the performance of the manager the consultants has recommended. This may be because there is a wealth of independently verified, easily comparable information on the performance of managers and strategies. Some consultants have also made significant investments to create large databases to monitor the performance of the managers they recommend. However even there, the absence of a consistent, standardised approach limits the usefulness of this tool for investors.

8.137 For example, one consultant told us they regularly publish the performance of the managers they have rated highly. The information is calculated using their own methodology rather than an industry standard which makes market-wide comparison difficult. The performance information was not for individual managers, but was aggregated at an asset class level. Additionally, there was no comparator for investors to compare against. The information tended to show the absolute performance of those funds, and not the performance relative to the non-highly rated managers. This means that investors will not be able to isolate the value added by the investment consultant's ratings process.

8.138 We reviewed a sample of performance information given by consultants to their clients. This was a limited sample and relates to manager performance, not asset allocation advice. However, some of the better and potentially poorer practices we observed included:

Some advisers presented the returns and volatility achieved against the objectives of the scheme, including the value added by hedging and LDI strategies, rather than merely showing the performance of the underlying components.

One consultant demonstrated the impact that decisions to change funds in the portfolio had on returns. Although this showed gross returns rather than performance net of fees, it also showed whether the new fund had outperformed relative to the fund it had replaced. This allows the trustees to better understand the impact of their decisions over doing nothing.

Some consultants showed the returns that could have been achieved from a passive alternative.

One firm showed whether the underperformance of funds relative to their benchmark could be explained solely by the impact of fees, or whether it was due to both fees and poor management. Trustees can see the impact of fees and potentially negotiate with asset managers from a more knowledgeable position. Other consultants split out the impact of cash contributions from underlying returns.

Some firms made potentially complicated information easy to understand by using a rating system (such as 'RAG' statuses) to demonstrate how funds were performing against various important and relevant metrics, such as tracking error and volatility.

One consultant showed the performance of the scheme compared to other schemes advised by the same adviser. They gave little information about the size or maturity of the other schemes, how they had been selected and whether they were relevant comparators. Trustees could not examine whether the way their scheme is being run is successfully meeting its own objectives.

A number of firms presented fund performance in a way which made it unclear if the returns shown were gross or net of fees. Performance fee arrangements were complicated and they gave little explanation about the potential impact on returns had little explanation.

Documents tended to use jargon and abbreviations without clear explanations. Documents tended to make no attempt to make it easy and accessible for investors including lay trustees to read and understand.

Some advisers did not appear to provide breakdowns of performance by fund, but rather by asset class. Some advisers only gave information on discounts to list prices of funds, and not the actual fees incurred.

Some advisers used monitoring advice documents as an opportunity to advertise other products and services being developed by the adviser.

8.139 Almost all market participants we spoke to said the advice consultants gave should be evaluated more regularly, objectively and thoroughly. A standardised way to assess the quality of advice which investment consultants provide or to assess how consultants add value would help investors scrutinise their performance and assess whether they are achieving value for money.

8.140 We found that some progress is being made. Some trustees are increasingly recognising the importance of scrutinising the advice given by their consultants and whether their consultants are adding value. TPR has also recently released guidance for trust-based occupational schemes how they can improve governance of their scheme including on how to manage their relationship with their advisers.[325]

Monitoring of advice given by EBCs to DC schemes is even less frequent

8.141 Assets in DC schemes have gone up significantly because of automatic enrolment and the closure of DB schemes and this trend is expected to continue to grow. We heard that for DC schemes monitoring the quality of advice given by EBCs is even less frequent than DB schemes. Within DC schemes trust-based schemes are more likely to have better monitoring arrangements than contract-based schemes.

8.142 EBCs told us that when they advise employers who want to set up a DC scheme they offer one of two approaches. The first is a 'bespoke' approach where the EBC creates a bespoke DC scheme which includes designing the asset allocation strategies (often based on an analysis of the demographics of the employees) and selecting the underling range of funds (default option and self-select funds) that should be used. Alternatively, EBCs will simply suggest an 'off-the shelf' strategy designed by a pension provider. EBCs told us that smaller pension schemes tend to choose 'off-the-shelf' schemes.

8.143 Most EBCs told us they review bespoke schemes more frequently, generally every three to five years. This in turn would be an opportunity for the client/employer, if willing and able, to review the quality of the EBC's advice. Opportunities to do this for 'off-the shelf' schemes are less frequent. A few EBCs said that they regularly review the 'off-the shelf' strategies offered by the main DC providers to consider the 'reasonableness' of the overall asset allocations. If they think these are no longer suitable, they may flag this to the employer. In general, however, most consultants said they did not hold any responsibility for 'off-the-shelf' strategies and the provider retains responsibility to ensure solutions are fit for purpose.

8.144 We heard that in contract-based schemes, while consultants or EBCs are involved in setting up the scheme, their ongoing engagement is typically minimal. Most employers are not encouraged to devote resources to monitoring the EBC and there is no structured engagement for continued monitoring and scrutiny of the EBC's advice. This may be less of a problem for trust-based schemes, where trustees will undertake ongoing monitoring. However for hybrid schemes, i.e. a pension scheme with both DC and DB sections, we heard that unless there was an investment committee to look specifically at the DC scheme, the DB scheme would take up most of the trustees' time.

8.145 Requirements introduced for trust-based schemes[326] and IGCs to regularly monitor the performance of their DC schemes may result in an increase in scrutiny of EBCs in the future.

Without performance information institutional investors focus on other factors

8.146 In the absence of a systematic way to measure performance, clients focus on other features of the investment consultant's service. Some said that they reviewed the consultant's speed in responding to questions, as well as the quality of responses. Clients also consider how willing consultants are to be flexible in their reporting, to meet trustee needs. They benchmark costs, using industry surveys to assess whether they are being charged appropriately. In some cases, they may consider the fee discounts their consultant has secured from asset managers.

325 From July 2016 the TPR's DC Code of Practice 13 Governance and administration of occupational trust-based schemes providing money purchase benefits came into force. Accompanying this are six guides to support trustee boards in meeting the standards set out in the Code. The six guides cover: The trustee board; Scheme management skills; Administration; Investment governance; Value for members; and Communicating and reporting

326 These were introduced by the TPR in the *Code of practice no: 13 Governance and administration of occupational trust based schemes providing money purchase benefits* www.thepensionsregulator.gov.uk/docs/code-13.pdf

8.147 Investment consultants seem aware of the difficulty in monitoring their advice and argue that investors look for and value aspects of the investment consultancy service, like trust and the ability to explain things to trustees. Almost all the consultants we spoke to said that they monitored feedback from their clients through informal discussions or periodic feedback. While these surveys assess the trustees' views of working with the consultant (which is an element of the consultant's service), consultants are not assessing the part of their service that is likely to have the biggest impact on their client's outcomes- the quality of their advice.

8.148 This in turn means that consultants focus on competing on other factors rather than on how well their advice has performed. The larger consultancies take advantage of their branding and position in the market. This particularly appeals to institutional investors because they cannot be faulted for selecting an established well known company for their consultant.

Not being able to assess quality makes it difficult to challenge and assess consultants

8.149 From our one-to-one meetings with institutional investors we found that most felt that their consultant adds value in some way. This can be through bringing expertise that is not available to the trustees particularly for lay trustees, and/or training trustees on new ideas and concepts that they are not familiar with. Where the relationship works well, consultants can help trustees understand their investment objectives and put together an investment strategy to achieve the scheme's required performance targets while following the trustees' investment beliefs. Consultants can also improve trustee decision-making by suggesting ways to streamline long decision-making chains and improving governance. Some consultants may also negotiate with the asset manager on the investor's behalf and help them achieve a good price for the services they are buying.

8.150 However, from in our meetings with institutional investors it also emerged that all these factors seem to work best with trustees who have sufficient expertise themselves to bounce ideas off their consultants, rather than solely relying on the consultant and blindly following their advice and recommendations.

8.151 33% of respondents to our online survey said that they only rarely challenged consultants. Similarly TPR research has suggested that 24% would never disagree with external advisers.[327] Our academic research into trustee behaviour[328] also found that trustees may be unwilling to challenge as a result of the fear of complexity and looking unknowledgeable in front of peers. A number of pension schemes said they were unwilling to go against their consultant's advice. This was mainly driven by fear of being liable if investor expectations are not met.

8.152 The ability of institutional investors to get good outcomes from their consultants depends on the robustness of the investor's internal governance structures, the composition and investment expertise of the trustee board and how well resourced the pension scheme is generally. For example, for pension schemes with less resource to support their governance, the consultant's influence may be magnified and investment consultants can 'take over', setting the agenda of board committee meetings and playing an influential role in decision making. Pension schemes that are well resourced and have a dedicated investment team may still use a consultant for advice but rely on them less heavily.

8.153 On the other hand, investment consultants told us that institutional clients regularly ask to see the methodology and analysis underpinning their advice, including their recommendations on funds, products or strategies. However, they added that this is not the case across all their

327 Trustee Landscape Qualitative Research 2016 www.thepensionsregulator.gov.uk/docs/trustee-landscape-qualitative-research-2016.PDF

328 Tilba, Baddeley & Liao (2016)

clients and varied depending on the circumstances and the board's financial knowledge. They found clients who were more likely to challenge included the larger schemes, professional trustees, independent trustees, and generally any client with a higher level of knowledge and experience of investments. Clients less likely to challenge tended to be schemes which have less governance in place or less resource to dedicate to governance.

We found limited transparency and consistency in the fee information provided by fiduciary managers to institutional investors

8.154 Fiduciary management fees appear to be one of the most unclear parts of the asset management industry. From our sample of firms we found that, while firms generally provided the AMC or OCF of fiduciary management products, there was no consistency in the use of AMC or OCF, which made comparison difficult. Surprisingly, one of the larger fiduciary managers said that fee information is available on request and not provided to all clients as a matter of course. Most fiduciary managers said they provide information on fees and charges early in the decision-making process, although it was not clear at what point.

8.155 Most fiduciary products are fund of fund or multi-manager products and so clients will typically also incur fees from underlying managers. Some fiduciary managers told us that the fees of individual underlying managers are not usually disclosed to clients because of confidentially agreements with those managers. However, they would provide management fees aggregated on a portfolio or asset class level; there was no indication that this would include transaction costs.

8.156 This lack of transparency of fiduciary management fees may mean that some clients are not aware of the charges they pay. For example we heard that some fiduciary managers levy manager selection fees directly on the client's assets without making this explicitly clear.

8.157 Anecdotal evidence from institutional investors and investment consultants suggests trustees are recognising this information gap. For example, one charity noted that they set a 'fee cap' and ask their consultant to report on the aggregate cost of running the investment strategy (e.g. advice, custodian costs, investment related costs, platform costs, etc.) within that cap. In this instance the model worked well because the charity has the resources and skilled personnel to monitor the quality of the fiduciary manager's advice and recommendations.

There is limited independent monitoring and scrutiny of the fiduciary manager – mainly the result of insufficient comparable data available to assess cost and performance

8.158 Where trustees have delegated decision-making to the investment consultant, they rely on them to follow the investment strategy they have set. In such instances the effective reporting and monitoring of investment outcomes becomes increasingly important.

8.159 Even though fiduciary management offerings compete with asset managers, fiduciary managers do not face the same level of scrutiny. Asset managers suggested that the quality of due diligence for fiduciary managers is lower than for traditional asset management products, although the same operational robustness is required for both. This is partly because there is no pressure on fiduciary managers to disclose performance information on publically accessible sites or databases nor are there regulatory standards governing how performance information is calculated and presented.

8.160 We found that where information is provided it is not always clear or complete. For example, one document we saw had a broad statement suggesting that the consultant's fiduciary management service had on average achieved 6% outperformance of the pension protection fund (PPF 7800 index) over the last five years. It was unclear whether this return was net of charges, what level of risk had been taken to achieve this, or how outcomes may differ depending on the level of variation between clients of different sizes, funding levels and with different needs.

8.161 Monitoring fiduciary management poses some of the same difficulties in evaluating advice mentioned earlier. Fiduciary managers told us that devising standardised performance metrics that could be used by all fiduciary managers across all of their clients is very difficult because clients have different investment objectives, strategies and goals which are bespoke and unique to them. They argue that this makes peer group comparisons between fiduciary managers difficult and potentially misleading.

8.162 We think the challenges identified in monitoring investment consultant performance can be overcome. Before the creation of the Global Investment Performance Standards (GIPS)[329] for asset managers, there were concerns around managers cherry-picking best-performing funds, or comparing funds where the risk profile of the funds was not comparable. After GIPS, asset managers are under significant commercial pressure to confirm their compliance with GIPS standards. To comply they must present performance information to clients on a composite basis using a standardised format, rather than by offering data on a single fund which shows the performance of the manager in a favourable light. So there is precedent for successfully implementing industry initiatives which improve transparency and reporting.

8.163 We understand that the market is moving towards more standardised reporting in the fiduciary management sector. If successful and publically available, this should address some of the lack of clarity around information and data on the performance of fiduciary management. However, we have concerns about whether this will be readily accessible to current and prospective clients. As it currently stands, firms and consultants are developing these performance metrics for use with their clients. Unless these are made publically available, they would not address the general lack of transparency across the market.

8.164 As mentioned above we have seen advisory firms offering an 'independent' evaluation service. These advisers help schemes run fiduciary management tender processes and also help with ongoing monitoring. One consultant told us that the emergence of this service in effect mitigated the conflict of interest risks that arise. But another consultant pointed out that these independent evaluators were also conflicted because they may have incentives not to recommend a fiduciary arrangement. Instead independent evaluators were likely to recommend that clients were better suited to traditional consultancy services and then recommend that the clients use their own advisory services. Some institutional investors we spoke to told us they take care not to employ a competitor investment consultant to fulfil this role. Consultants are aware that their services are being evaluated by third party evaluators, although they do not always know when this is being done. Investment consultants suggest that third party evaluators are more common for clients that use their fiduciary management services. According to KPMG survey 23% of new appointments were advised by an independent third party[330] and 13% use an independent provider to monitor their fiduciary management provider.

8.165 However this may not be the solution for all clients as it adds further costs and there may be further conflicts as well. One consultant told us that the cost associated with having an independent evaluator may mean that the scheme can then not afford to go into fiduciary management.

8.166 Moreover as the market develops, competitive tendering is expected to become more frequent. However whether tendering processes are competitive depends on the quality of data available and how comparable it is. Improved transparency and competition between the fiduciary managers should improve outcomes for investors using these services.

329 The GIPS standards are a set of standardised, industry-wide 'ethical principles' that guide investment firms on how to calculate and present their investment results to prospective clients. They include composite presentation, which aims to improve transparency by eliminating survivorship biases, misrepresentations and historical data omissions.

330 KPMG *Fiduciary Management Survey* 2015

Questions for discussion and next steps

8.167 This chapter has looked at how investment consultants affect competition between asset managers. We welcome views on whether there are additional factors and features of the investment consultancy sector which we should take into account before the final report.

8.168 Between now and the final report we will conduct further analysis into:

- The relationship between gifts, hospitality and revenues from asset management groups and the ratings given to them by investment consultants.
- The finding that on a gross basis both recommended and not-recommended products outperform their benchmarks. This requires further investigation as it suggests that on average institutional products outperformed their manager-specified benchmarks. This could reflect genuine outperformance by institutional products, in which case (given that there is a zero sum game across fund and non-fund investors) other investors must collectively have been underperforming.

9. Are there barriers to entry, innovation and technological advances?

We looked at product development and innovation in the asset management market. We also considered whether there are barriers to competition, particularly where they reduce the incentives or ability to innovate and introduce technological advances.

We find that:

- there is some evidence of innovation, particularly in investment products and strategies. However, some of the developments we have seen are more likely to have an 'evolutionary' rather than 'revolutionary' effect on competition in the medium to long term. We do not see innovation in the ways active management firms charge for their services and we would be interested in further exploring the reasons why.
- there is limited evidence of significant structural or regulatory barriers to entry in the asset management market.
- there are ways in which intermediaries and distributors can both encourage and act as a barrier to innovation in the market for some asset management products and services.

We continue to consider innovation in the market and welcome further discussion on these topics

Introduction

9.1 We have looked at how innovation has occurred within the asset management market and have identified recent trends in product and service developments.

9.2 To understand whether any features of the market are preventing firms from innovating in the interests of investors, we asked for views through our information requests to asset managers, platform providers and investment consultants. We also held a roundtable to give stakeholders an opportunity to tell us about any specific regulations or market features which they felt created barriers to entry and innovation.

9.3 In doing so, we considered the following questions:

- How has innovation occurred in the asset management sector?
- Are there barriers to entry, expansion and innovation in the asset management sector?

- Are there features of the market or the behaviour of other parts of the value chain which inhibit innovation?

How has innovation occurred in the asset management sector?

9.4 To understand the motivations for asset managers to innovate we asked them what had driven recent growth or contraction in their business. We analysed the responses to assess the role that innovation plays in driving the growth of asset management firms. The factors that asset managers suggested drove growth varied according to the firms' focus and specialism and firms' experience of wider macroeconomic factors and changing investor preferences. Nevertheless, growth was generally as a result of improving existing products or through developing new products and/or strategies.

9.5 Respondents suggested that a key driver of growth was improving service quality to maintain existing client relationships. Firms suggested that focusing on improving technology through, for example, increasing the quality and quantity of client reporting would be one way of maintaining existing client relationships. Investing in new information sources or analytical tools could help firms to improve their existing investment strategies which, in turn, could improve performance and ensure clients stay with the firm.

9.6 Some respondents also suggested they are using Big Data techniques to serve clients in different ways and are buying services from new kinds of market data providers who are using Big Data technologies to analyse markets. For example, we have heard that asset managers could use these techniques to match clients' underlying holdings to 'open source' data about the client, to identify potential sales opportunities or to refine their product offering to better meet client needs. We were told that these techniques can also be used in factor-based investment strategies[331] and more generally to identify potential investment opportunities. These trends suggest that innovation plays a role in improving firms' existing client offering.

9.7 Nevertheless, we have not observed radical transformation in the way in which asset managers deliver their existing products. We understand that the way in which distributed ledger technology (for example, blockchain) can be used is being explored by several market participants in the asset management market. For example, custody and clearing processes and the trading and transfer of illiquid products have been mentioned as potential areas where this technology could be used. We understand that this is currently in discovery stage, although it could be the source of significant innovation in the future.

9.8 Asset management firms told us that, in addition to improving their existing client offering, they attracted clients by innovating to deliver new products and investment strategies. Several firms told us that new products have proved popular with investors. These include enhanced index products (including smart beta and passive factor products), outcome- focused products (including absolute return funds), LDI, and Environmental, Social and Governance (ESG) investing. The success of these products and investment strategies generally depends on investors' risk appetites and their views of specific asset classes and product types. We now turn to consider these products and strategies in more detail.

331 Where the investment strategy aligns investments to factors which have historically been able to explain improved risk-adjusted performance.

9.9 In contrast to passive funds which aim to track an index, smart beta and passive factor investing[332] aim to follow additional index construction rules or 'factor overlays' in order to achieve, for example, higher or more consistent returns over time. The most common factor overlays observed in the UK smart beta market include low volatility, fundamental and momentum investing.[333]

Factor investing

Factor investing is not a recent innovation. It is based in academic thinking going back to the 1960s which identified certain characteristics or 'factors' that can explain securities' historic risks and returns. Asset managers apply and implement investment strategies aligned with certain factors in order to achieve a return for the fund investors.

Different passive factor investing styles aim to capture returns that might otherwise be overlooked during traditional market-cap based index creation. These factors are believed to rebalance the index away from perceived biases or inefficiencies in the market.

9.10 Smart beta strategies have recently been applied to Exchange Traded Funds (ETFs), meaning that they can be a low cost way of accessing a factor-based strategy, and are often not significantly more expensive than comparable passive funds.[334] As an example, in 2015 FTSE All-Share smart beta ETFs charged an average TER of 0.42% (comparable market-cap weighted ETFs charged an average TER of 0.33%).[335] As Figure 9.1 shows, more than 3% of assets under management are now held in enhanced index style investments.

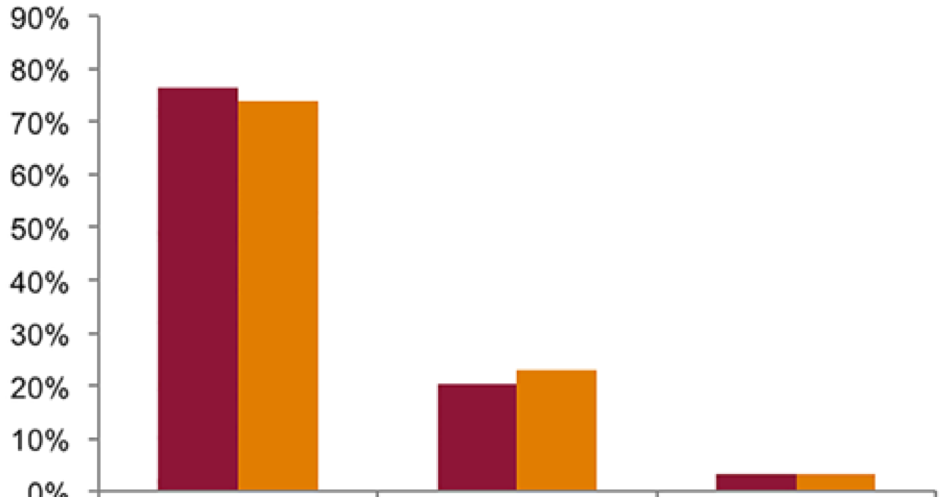
332 Smart beta and passive factor investing are also known as enhanced index, strategic beta, active beta, alternative weighted funds, scientific beta and many other names. There is no common definition for these kinds of strategies and the underlying methodology in their composition can vary quite significantly though we have considered them together here as being representative of the same phenomena.

333 Low volatility investment aims to achieve returns from those investments which represent the lowest variation in returns over time. Investing using analysis of fundamentals attempts to evaluate a stock or security's intrinsic value when compared with their market price. Momentum tries to capture those stocks or securities which have had high returns over a recent period. Smart beta funds may readjust the normal market-cap weighted formulas of passive index construction to reflect the factor that it is seeking to represent.

334 ETFs are often lower cost than traditional passive funds for several reasons including the efficiency captured through the fund being traded on the market which would otherwise require more expensive administration, for example, to meet redemptions.

335 Average bid-offer spreads for market cap were 0.45% whereas for smart beta ETFs the spread was 0.40% media.morningstar.com/uk/MEDIA/ETF/AssessingtheTrueCostofStrategicBetaETFs.pdf

Figure 9.1: Percentage of AUM in the UK which is managed according to different methodologies



	Active	Passive	Enhanced index/partly active or other
2014	76.40%	20.20%	3.40%
2015	73.70%	23%	3.30%

Source: IA data

9.11 In the last few years, outcome-focused investment products have become more popular. These products are intended to meet a specific investment objective. In contrast to, for example, traditional active equity funds which intend to beat a benchmark, examples of outcome-focused products include funds that are managed to avoid volatility levels above a certain level or a fund that aims to achieve a certain return by a target date. Diversified Growth Vehicles including targeted absolute return funds[336] and funds benchmarked against risk ratings or targets[337] could all be considered as examples of outcome-focused strategies. Many outcome-focused products are multi-asset[338] funds and fund of funds.[339]

9.12 Targeted absolute return funds have grown from 4.4% of total funds under management in 2013 to 5.8% at the end of 2015.[340] In four of the last eight quarters, targeted absolute return funds were the bestselling funds in the retail sector, with sales of £1.9bn[341] and have

336 Often considered to be a type of DGVF these funds aim to deliver a targeted return which should be delivered in all market conditions. Often the targeted return is formulated as 'cash plus' or 'LIBOR plus' and is not measured relative to a market benchmark.

337 The intention of these funds is to match the risk profile of the client with the product. In structure they are multi-asset funds which are either rated against a certain risk rating scheme, or targeted to be in line with a risk scheme's criteria. Risk targeted funds must stay within the relevant risk range (whereas risk rated can be reassessed and move in and out of certain risk 'buckets').

338 Mulit-asset funds include multiple types of assets, for example bonds and equity, rather than just focusing on one asset type often with the intention of adding diversification. They have also been known as balanced funds.

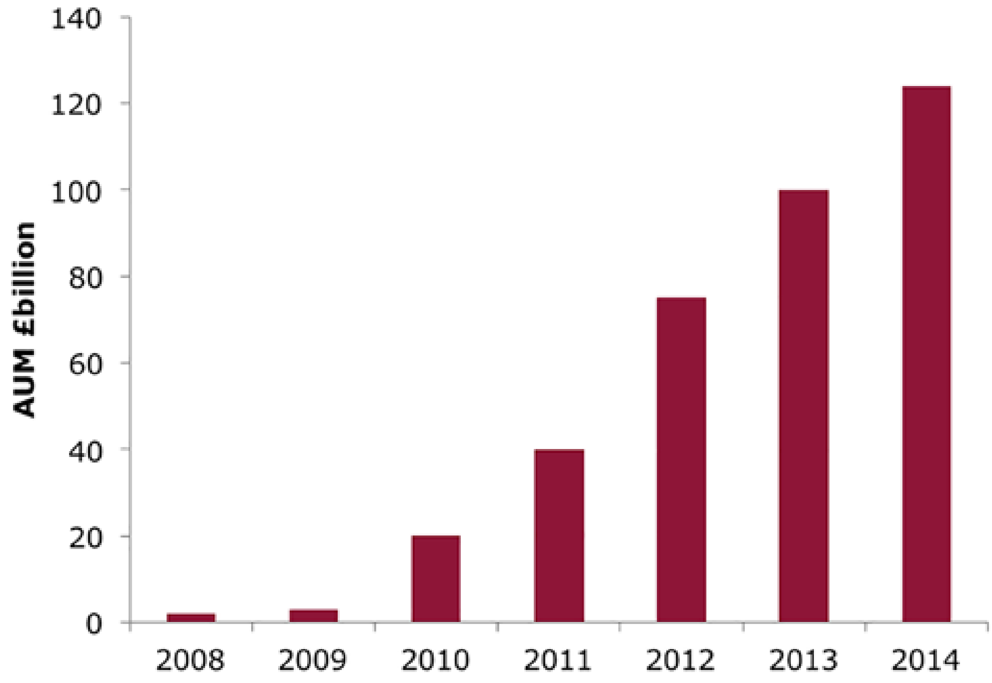
339 Funds which invest in other funds rather than investing directly in securities.

340 *Asset Management in the UK 2015-2016*, A summary of the IMA Annual Survey (September 2016) www.theinvestmentassociation.org//assets/files/research/2016/20160929-amsfullreport.pdf

341 Investment Association – Statistics by Sector, Best and Worst Selling Investment Association Sectors, By Quarter – Accessed 11 August 2016 www.theinvestmentassociation.org/fund-statistics/statistics-by-sector.html?what=table&show=24

also proven popular with institutional investors.[342] For comparison, other popular sectors were Europe ex-UK (£1.7bn), UK equity income (£1.6bn), property and global equity income (£0.8bn).

Figure 9.2: Estimated AUM of UK Diversified Growth Funds



Source: Spence Johnson data[343]

9.13 Another example of outcome- focused innovation is in LDI where the investment strategy is based on the requirement to pay current and future liabilities. Firms in our sample attributed growth in the assets under management in DB pension schemes to winning LDI mandates. LDI mandates can be both pooled and segregated, with the larger pension schemes more often opting for segregated structures.[344] Growth has been particularly significant in pooled LDI, where the number of pooled mandates increased by 41% in 2015 (equivalent to an 85% increase in total liability hedged).[345] In 2015, the number of pooled mandates overtook the total number of segregated mandates for the first time. Smaller pension schemes (less than £50m) are the least represented in the market both in terms of liabilities hedged and number of mandates.[346]

9.14 We have heard that firms are increasingly offering variations of their LDI strategies including 'enhanced' solutions (which include a combination of pooled and segregated structures) and Full Discretion Hedge Management (where the provider makes all decisions about the hedging strategy for the client).

342 Based on information provided by our sample of asset management firms.

343 www.plsa.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0448-DIVERSIFIED-GROWTH-FUNDS-MADE-SIMPLE-v2.pdf

344 Navigating the LDI market 2014 market kpmg.co.uk/email/06Jun14/OM016838A/files/assets/common/downloads/Navigating%20the%20UK%20LDI%20Market.pdf

345 KPMG *Navigating the UK LDI Market* (2015)

346 Ibid. These numbers do not fully reflect the industry as two of the three largest managers are unable to split their mandates out by size.

9.15 The growth across LDI has been concentrated in a small number of LDI managers; the largest three managers had more than 80% of the total liabilities hedged in 2014, including segregated mandates and pooled mandates.[347] The market for pooled mandates is slightly less concentrated. The big three providers account for 75% of the market and this is where the majority of new business was concentrated in 2014.[348] However, investment consultants and clients were generally happy with the product and the price paid and noted that LDI is a scale business so they would not expect to see lots of providers.

9.16 Views are mixed on the prevalence of Environmental, Social and Governance (ESG) strategies and how this may be changing over time. It appears that demand is being driven by investors changing their focus while providers are making efforts to take stewardship considerations into account. In a recent sample of 34 IA members, half reported that they managed at least some proportion of assets according to ESG considerations and, where they did, approximately one fifth of total assets were subject to ESG requirements.[349]

9.17 The motivation to innovate by introducing new products and strategies appears to be partly driven by wider market changes. Some firms suggested that pension freedoms have driven demand for products that aim to deliver a certain outcome for investors. We were told that outcome-focused products are also popular amongst financial advisers looking for a simplified way to match their clients' risk appetite to an investment product. Two of our sample of asset managers put a significant part of their growth down to promoting their multi-asset strategies in the face of these changing market conditions.

9.18 As well as looking at innovation in new and existing products and strategies, we considered whether there has been innovation in the way that firms charge for actively managing funds.

9.19 Asset management firms do not typically compete strongly on price for active products. Firms typically charge a percentage of assets under management and told us that they price at or around the price of their competitors. Some funds charge performance fees in addition to a percentage AUM charge. These fees typically reward firms for positive performance but do not penalise them for any negative performance. Retail investors are not commonly charged performance fees[350], although they are more common for targeted absolute return funds.[351]

9.20 We have also not found significant innovation either on pricing models for asset management products or pressure from clients for alternative fee structures. As we discuss in Chapter 6, the current ad valorem fee structure can create a potential conflict between an asset manager's incentive to grow the size of their fund and investors' interests to generate returns, particularly if performance suffers due to decreasing returns to scale. We are interested to understand whether there are barriers preventing firms from introducing alternative pricing models. For example, we might expect there to be a place for pricing models where the risks and rewards of performance are shared between the investor and the asset manager or models where the benefits of scale are passed on to retail investors in a similar way to institutional investors.

9.21 We are interested in further views on pricing models that involve a greater element of risk sharing and sharing economies of scale, including any practical difficulties in passing scale benefits on to investors.

347 Ibid

348 Ibid

349 www.theinvestmentassociation.org//assets/files/research/2016/20160929-amsfullreport.pdf

350 As part of our analysis we created comparable data set for a small sample of 4 fund managers which illustrated that performance fees are a relatively small proportion of firms' revenue (averaging a charge of 1.8 bps).

351 Of the 94 targeted absolute return funds we analysed, 43 had performance fees.

Are there barriers to entry, expansion and innovation in the asset management sector?

9.22 We wanted to understand whether there are barriers which might prevent firms from entering, competing and innovating further in the asset management sector. Our analysis suggests:

- existing firms have an advantage when launching new funds
- ancillary service providers may have minimum revenue requirements, but outsourcing generally reduces the costs of establishing an asset management firm
- there is limited evidence of specific regulations that prohibit entry and innovation.

Incumbent firms have an advantage when launching new funds

9.23 We understand from stakeholders that there is a minimum viable fund or mandate size.[352] If a fund's size is less than this, it is unlikely to be financially viable. This minimum size is due to the fixed costs of running a fund, such as capital requirements, legal advice and promotional costs. Funds have to attract a certain amount of AUM to cover these fixed costs. As with many other kinds of business, when new funds are launched there may be an initial period where client acquisition numbers, and, as a result, revenues are low, but the firm is incurring costs. Funds need to survive through this initial period in order to become viable.

9.24 We heard from respondents that there are two main factors that affect how likely it is that a fund will reach the minimum efficient scale to become viable. First, the fund will need to demonstrate that it has a performance track record, without which it may not survive. Second, some asset management firms may be willing to source seed investment for their funds to cover the initial start-up costs.

9.25 We were told that incumbent firms are more likely to be able to generate the performance track record and seed funding to reach this viable scale. If an individual asset manager or team has an existing track record of managing funds at a current asset management firm, they may find it easier to gain the minimum scale to operate a fund. Existing asset management businesses may also have more capital available to use as seed money to cover the fund's start-up costs.

9.26 In contrast, there may be barriers to new asset managers. They may be unable to raise enough money in their early stages or leverage off the performance track record of other funds to create a viable new fund or fund range. New firms are unlikely to be able to charge higher fees to cover their initial start-up costs because this would have an effect on the fund's performance and attractiveness to investors.

9.27 Some institutional investors will put contractual limits on the amount of exposure they are willing to accept. This can apply either to a single asset management company or certain products. While these limits are meant to ensure a diversified investment portfolio, they will limit the ability of large institutional investors to use small asset managers or small funds. This is because they would need to make many smaller investments to avoid breaching their own exposure limits. As a result, they may be more likely to use a larger asset manager to avoid these breaches.

352 Stakeholders' views varied on this point, but based on what we were told, a fund size of approximately £100m appears to be a reasonable approximation for the size needed to be viable.

Ancillary service providers may have minimum revenue requirements, but outsourcing in general reduces the sunk costs needed to establish an asset management firm

9.28 Part of the costs of running a fund are ancillary services which, depending on the service, can either be undertaken by the fund manager or by a third party. The cost of undertaking many ancillary services in-house is typically high and so they are often outsourced.

9.29 Outsourcing ancillary services reduces the cost of entering the asset management market as it allows new entrants to both minimise and had to develop in-house provision of these services their costs would likely be significantly higher.

9.30 We explored whether buying certain ancillary services acts as a barrier to new asset managers entering the market. This could either be because ancillary service providers refuse to serve new entrants or because charges to new entrants are prohibitively high.

9.31 Asset managers will typically need a credible five to ten year growth plan before ancillary service providers will consider providing services to them. The providers we spoke to said that they may be unwilling to take on clients that do not have a proven track record unless they are a well-known name.[353] Providers told us that strategic factors also play a role in driving their pricing and client acquisition decisions. These factors include whether or not there is an existing relationship with the asset manager and current or future opportunities for selling them other services. This gives larger and established asset managers an advantage, as they are likely to represent a better business proposition to providers.

9.32 The cost of many ancillary services is largely activity driven. So the smaller the asset management firm, the lower their charges for ancillary services. However, some providers told us that they would expect to get minimum revenues before they would take on a new client. Some firms suggested they would look for approximately £250,000-£500,000 in annual revenues across all services they provided to the asset manager. Some of the providers we spoke to were also willing to offer a better price or discount even if the manager was small if, for example, the manager had a good track record and their growth projections were realistic and attractive.

9.33 Although some ancillary service providers require a minimum level of revenues, there are alternative routes to access these services, for example through host Authorised Corporate Director structures.[354] These allow smaller managers to aggregate their funds with similar managers to offer service providers a more profitable proposition.[355] Additionally some host Authorised Corporate Director providers also offer in-house fund administration, accounting and some transfer agency.[356]

There is limited evidence of specific regulations that prohibit entry and innovation

9.34 Respondents to our information request and those who attended our roundtable told us that there are regulatory barriers to innovation. However, they felt this was more about the overall scale of regulation, rather than specific regulations. They did not identify many specific regulations which they felt created barriers to entry or innovation, but we have highlighted those they mentioned below.

353 The name in question here may be the individual asset manager's or could be an association of the staff with a larger manager, for example in cases where small groups of staff 'spin off' and create their own boutique manager.

354 Authorised Corporate Director s are authorised corporate directors who are required by COLL rules to be the director of an ICVC. Host Authorised Corporate Director s offer third party independent fund hosting capabilities and will undertake the activities of the Authorised Corporate Director .

355 Additionally, Host Authorised Corporate Director s will likely have relationships with multiple ancillary service providers, and this may be advantageous more generally for smaller asset managers who might otherwise struggle to compare providers in order to get a good deal.

356 We understand that increasing proportions of host Authorised Corporate Director services are also now being outsourced to the larger ancillary providers as the existing Authorised Corporate Director s are unable to achieve the same efficiencies for these services.

9.35 Stakeholders told us that the overall level of regulation has increased in recent years and creates a barrier to entry. Smaller firms in particular highlighted the time and cost associated with implementing forthcoming regulations such as MiFID II, and said that this can prevent them from spending money on product development or improving efficiency.

9.36 All FCA-regulated firms must comply with the Handbook rules relevant to their business. The requirements for being a regulated firm vary widely depending on the types of activities the firm undertakes and the permissions held, although there are baseline requirements that all regulated firms must meet. We have not considered the general FCA regulatory requirements in this document; we have looked at those that place specific requirements on firms undertaking asset management activities.

9.37 Capital requirements are an example of a regulatory requirement that can potentially increase barriers to entry in some parts of the asset management market. However, capital requirements generally depend on the activities that firms undertake, such as the capital requirements as set out under AIFMD. Small AIFMs[357], for example, might need a base capital of between £5k and £50k depending on whether they meet certain thresholds, whereas full scope AIFMs will need to hold a base capital of £125k once they reach the qualifying threshold. Varying capital requirements depend on the greater or lesser risk firms pose to our statutory objectives. We may take longer to process applications if we need more information, for example, from a riskier firm. The application process can also take longer where businesses are particularly complex.

9.38 Stakeholders also raised further potential regulatory barriers to competition from AIFMD. Some stakeholders suggested that the requirement for depositories to have oversight of custodians (and fund accountants) may lead to the bundling of the two services, given the perceived difficulties for custodians overseeing external depositories. Liability requirements mean that the depositary will need a significant degree of assurance that custody is robust, and that they have full visibility over the service; respondents and stakeholders have argued that this is easier if the depositary firm also provides the custody. Similarly, when cash monitoring and valuation requirements fall on the depositary, but are more easily overseen by the fund administrator then, at a minimum, the depositary will be offered at a better price if it is bundled with fund administration. In some cases, these services may not be offered at all unless fund administration is also included in the package. This, in turn, could reduce competition for standalone custody provision. However, some respondents did not foresee this bundling being an issue.

9.39 Several market participants raised a general point that the cost of AIFMD compliance was significant and would make ancillary provision more expensive. One 2013 survey found that almost half of their respondents affected by AIFMD rated the cost of compliance as 'high' and a further third rated it as 'medium'. However, at least one market participant said that the initial and on-going costs have probably reduced since then.[358]

9.40 Under MiFID rules, asset management firms are required to have 'facilities' in every Member State where they have a presence. Several stakeholders raised the inconsistency of interpretation for what is meant by 'facilities' across Member States. It is unclear if this is due to the way different member states apply this rule, or whether firms are interpreting transposition of rules differently in different jurisdictions. In the UK a physical presence – ie a staff and an office – is a threshold condition for all authorisations, not just asset managers.[359] Market participants told us that the requirement for a physical presence is a barrier to entry not commensurate with the modern

357 Alternative Investment Fund Managers

358 KMPG/AIMA/MFA *The cost of compliance* www.kpmg.com/dutchcaribbean/en/Documents/Publications/The-cost-of-compliance-v2.pdf – Almost half (46%), a further third (33%). This was a global survey.

359 Physical presence is a threshold condition for authorisation in the UK (also referred to as Location of Offices) – see FCA Handbook COND 2.2. All firms must also have suitable human resource(s) in the member state in which they are based.

reality of how businesses work; clients can be serviced adequately online without a physical presence in a jurisdiction. We will keep this under review and would welcome any evidence of the extent to which this acts as a barrier to entry into the UK market for asset management.

9.41 We heard from respondents and roundtable participants that requirements to get unit holder consent before firms can move them to alternative share classes is acting as a barrier to improving value for money. As illustrated in Figure 9.3, there are many potential reasons why some investors may be in more expensive share classes when a cheaper alternative exists. Stakeholders mainly raised concerns about the RDR, where firms may have ceased their commission payments to UK investors but investors remain in the old shareclass.

9.42 Of the 30 firms that provided data, 21 asset management firms in our sample reported paying around £1.4bn in commission in 2015 and 9 stated they made no commission payments.[360] This figure includes payments made to UK and non-UK distributors and some payments which have since been ceased. It does not include rebates back to investors. In addition the figure does not capture investors that are in share classes where commission has been turned off. Nevertheless, this raises questions about the extent to which investors are aware that alternative shareclasses may be available.

Figure 9.3: Reasons for being in a more expensive share class

1) I nvestors are in a pre-RDR share class which is more expensive because they continue to pay trail commission
2) Investors are in a pre-RDR share class which is more expensive but the manager has 'turned off' trail commission
3) Investors are in a more expensive share class than others available through alternative distribution channels
4) The fund manager has launched a cheaper share class (but not for the reasons listed above) which would be available without switching distribution channel. This could be because an investor bought units in a legacy share class and subsequently a cheaper share class was launched. Alternatively, multiple share classes could have been distributed at the same time and the investor ended up in a more expensive one

Are there features of the market or the behaviour of other parts of the value chain which inhibit innovation?

9.43 Respondents suggested that:

- institutional distribution can both enable and restrict entry and innovation – this is discussed in more detail in Chapter 8.
- retail distribution can help asset managers to access clients, but heavy intermediation can reduce the ability of asset managers to understand their clients' needs – this is discussed in more detail in Chapter 5.

Questions for discussion and next steps

9.44 We welcome views on whether there are additional barriers to competition, innovation and technological advance which we should take into account before the final report.

360 The remainder either did not pay commission

10. Proposed remedies

We are considering remedies to make the asset management sector work better for both institutional and retail investors. The remedies aim to address the following concerns about the way in which competition appears to be working in the asset management sector:

- The evidence suggests there is weak price competition in a number of areas of the asset management industry. Our analysis shows mainstream actively managed fund charges have stayed broadly the same for the last 10 years, that there is price clustering for active equity funds and asset management firms have consistently earned substantial profits across our six year sample
- Our evidence suggests that actively managed investments do not outperform their benchmarks after costs and that some active funds offer similar exposure to passive funds, but charge significantly more
- While asset managers tend to be good at managing charges which are straightforward and inexpensive to control, they are less good at controlling costs for services which are expensive to monitor value for money
- Fund governance bodies do not exert significant pricing pressure by scrutinising asset managers' costs and do not typically focus on value for money
- We have concerns about how asset managers communicate the objectives and outcomes to investors. Investors may continue to invest in expensive actively managed funds which mirror the performance of the market because fund managers do not adequately explain the fund's investment strategy and charges
- While the evidence on investor focus on charges is mixed, we found that around half of non-advised retail investors were not aware they were paying charges, suggesting awareness of the impact charges can have on returns is still low
- Asset management firms told is that where they create a new share class they find it difficult to switch investors to these new, cheaper share classes
- On the institutional side, there are a large number of small pension schemes and trustees vary in how effective they are at negotiating on price. Some institutional investors also are not presented with comparable information on charges
- While investment consultants' due diligence ensures that 'rated' asset managers meet minimum quality and operational standards, these ratings do not appear to help institutional investors identify better performing managers or funds. Many institutional investors struggle to monitor and assess the performance of the advice they receive and we also have concerns about whether the interests of investment consultants are in line with investors' interests.

To address these concerns, we are provisionally proposing the following remedies:

- a **strengthened duty on asset managers to act in the best interests of investors**, including reforms that will hold asset managers accountable for how they deliver value for money, and introduce independence on fund oversight committees
- **introducing an all-in fee** approach to quoting charges so that investors in funds can easily see what is being taken from the fund
- helping retail investors identify the best fund for them by:
  - **requiring asset managers to be clear about the objectives of the fund** and report against these on an ongoing basis
  - **clarifying and strengthening the appropriate use of benchmarks**
  - providing tools for investors to **identify persistent underperformance**.
- making it easier for **retail investors to move into better value share classes**.
- requiring **clearer communication of fund charges** and their impact at the point of sale and in communication to retail investors.
- requiring **increased transparency and standardisation of costs and charges** information for institutional investors.
- exploring with government the potential benefits of **greater pooling of pension scheme assets**.
- requiring greater and **clearer disclosure of fiduciary management fees and performance**.
- consulting on whether to make a **market investigation reference to the CMA on the institutional investment advice market**.
- recommending that **HM Treasury also considers bringing the provision of institutional investment advice within the FCA's regulatory perimeter**.

We have also found that retail investors face difficulties understanding the full cost of investment, including distributor fees, and have some concerns about whether intermediaries deliver value for money. So we are proposing further FCA work on distribution in the retail market.

Introduction

10.1 We are considering remedies in several areas to improve the process and outcomes of competition for institutional and retail investors. In this chapter, we first set out the principles we use when considering remedies. We then set out our current thinking on potential remedies to address the concerns we have identified in this report. We would like stakeholders' views at this stage to help us in further developing our remedy package.

10.2 This chapter contains our initial thinking on remedies for discussion. Our final report will set out the final package of proposed remedies. The overall policy package will bring together a consistent and coherent framework of interventions. In doing so, we will take account of PRIIPs, MIFID II and the outcomes of our consultation on transaction cost reporting to pension schemes and Independent Governance Committees. We will consider the impact that remedies will have on the attractiveness of the UK as a place to do business and also the protections offered to UK consumers investing in a range of investment products.

10.3 We recognise that many different groups of investors use asset management services and we therefore need a targeted package of remedies that supports these different investor groups. For those that want to and are able to find better value in the market, we want to make prices and performance clearer and more comparable. We also recognise that some investors are not well placed to find better value and so we want to ensure intermediaries and asset management firms are acting in investors' best interests.

Key principles when considering remedies

10.4 We aim to ensure that any intervention is both effective and proportionate to the concerns identified.[361] When assessing remedies we consider:

- how the remedy addresses the interim findings and the detriment we have identified
- the tools available to us, including our powers and ability to make further rules, as well as ensuring consistency with relevant EU and domestic legislation
- how effective and proportionate the remedy, or package of remedies, would be
- how the different remedies are effective as a package of interventions to help make competition work effectively
- how the remedy, or package of remedies, supports other FCA work in the asset management sector

10.5 As set out in our market study guidance, we have a range of remedy options.[362] These include using rule-making powers and publishing guidance, supervision and enforcement action and giving the industry an opportunity to develop measures that ensure compliance and improve client outcomes. Any proposed rule-making remedies would require formal consultation and associated cost benefit analysis. We may also conduct behavioural trials to help inform how we design and implement remedies.

Potential remedies

10.6 In this section we outline the potential remedies we could take forward to improve the way in which competition is working in the asset management sector.

A strengthened duty on asset managers to act in the best interests of investors

10.7 As we discuss in Chapter 5, our evidence suggests that:

- the Authorised Fund Managers (AFM) of authorised funds generally do not robustly consider value for money for fund investors

361 We must have regard to the regulatory principles in section 3B FSMA when exercising our general functions, including rule-making
362 FG15/9: Market studies and market investigation references: A guide to the FCA's powers and procedures

- in particular, AFMs often do not compare the fees charged by the asset manager for managing a retail fund's portfolio with the fees the asset manager charges comparable institutional client accounts to assess if the difference in fees is reasonable, compared to the differences in costs

10.8 These issues are likely to contribute to a number of our findings. Some investors are unlikely to ever drive value for money effectively and therefore need strong governance to act on their behalf. Currently this does not appear to be happening, contributing to limited price competition for actively managed funds, asset managers being less effective at controlling more complex costs and specific funds not clearly communicating their investment strategy to investors. This results in investors choosing funds that are unlikely to meet their expectations.

10.9 While AFM boards have duties to act independently and in the best interests of investors, they do not currently have an explicit and well defined obligation to seek value for money for them. We are considering:

- Placing a duty on asset managers to demonstrate how their funds deliver value for money to investors
- Reforming governance standards for UK authorised funds to ensure asset managers are held to account for how they deliver value for money. In doing so, we might draw on the US model for fund governance
- Supervising and referring for investigation issues related to any new duties and governance standards.

10.10 In terms of specific duties, fund governance bodies could be charged, as a minimum, with assessing value for money for investors by:

- among other factors they decide, considering the reasonableness of the fund's fees, including any performance fee
- considering all direct and indirect expenses and charges met by the fund, including transaction costs
- considering whether it is in the interests of investors to institute tiered fee breakpoints at specified asset levels, or alternative fee arrangements, in order to share economies of scale with investors more effectively
- considering whether there are practices happening in the fund which are not in the best interests of investors, such as the fund manager taking 'risk-free box profits'
- to perform an annual, arm's length reassessment and, where appropriate, renegotiation of the investment management agreement (IMA) with the asset management company
- to make public an annual report detailing its activities in reassessing and renegotiating contracts and how it is ensuring value for money on behalf of the fund and its investors

10.11 We are considering the following options for reform to fund governance to help ensure firms deliver value for money. Fund governance could be reformed in the following ways:

- **A: Keep existing governance structure but clarify their duties:** The AFM Board[363] could be expected to demonstrate how it has complied with the strengthened duty to act in investors' best interests.

- **B: Strengthen the requirements on senior managers of the AFM:** The duties of the AFM board members will be strengthened by extending the Senior Managers and Certification Regime (SM&CR) to AFM board members, which is currently due to be applied to asset managers in 2017. We could seek to require that senior managers consider value for money as part of the introduction of this new regime.

10.12 Alternatively the existing governance structure could be modified in the following ways:

- **C: Change composition of existing governance bodies to create more independence:** The existing AFM board structure could be reformed to mandate having a majority of independent members and an independent chair.

- **D: Create an additional governance body:** A separate independent body could be introduced, modelled on the Independent Governance Committees for DC pension funds, to carry out the new duties, leaving the existing AFM board with its current responsibilities. The new body's obligations would be enforced by extending the SM&CR to its members.

- **E: Replace existing governance structures with new body:** Replace AFM Boards with majority independent fund boards, similar to the US Mutual Fund structure, with their responsibilities underpinned by the SM&CR.

- **F: Greater duties on trustees and depositaries:** An alternative approach would be to leave current AFM governance structures unchanged and impose greater duties on trustees and depositaries to assess whether the fund manager is delivering value for money.

10.13 We believe that similar standards of governance should apply to UCITS and AIFs, where the AIFs are distributed to UK retail investors.

10.14 An alternative approach to that set out above would be for the FCA to ask the government to consider introducing a statutory duty of care or fiduciary duty between asset managers and their investors. We believe that our proposed reforms could achieve a similar result, but would allow us to provide firms and consumers with greater detail of the relevant requirements.

10.15 However, we welcome views on whether the FCA recommending the government introduce a duty by statute would bring advantages over and above our preferred approach, which is to pursue regulatory change through the above options.

363 We are referring to the board of the management company: the Authorised Corporate Director (Authorised Corporate Director) for OEICs and the Unit Trust Management Board for Unit Trusts

Questions for feedback

- What is the likely effectiveness and proportionality of:
  - the FCA setting out its expectations about how AFMs should demonstrate that they are acting in the best interests of unitholders
  - governance reforms to help ensure firms comply with their responsibility to act in the best interests of unitholders
  - the specific options (A-F) set out above
- Do you have views on how firms should demonstrate that they have acted in the best interests of investors?
- Do you have views on how governance should work to ensure firms act in the best interests of investors?
- Are there any logistical challenges and unintended consequences that should be taken into account? If so, how could these unintended consequences be overcome?
- Are there advantages to the FCA recommending the government introduce a fiduciary duty by statute which could not be achieved through regulatory reforms?
- Are there better alternative supply side remedies that would encourage asset managers to demonstrate that they are providing value for money?

Introducing an all-in fee so that investors in funds can easily see what is being taken from the fund

10.16 As we outline in Chapter 7, we have found that some charges, particularly transaction costs, are not disclosed to investors before they make their investment decisions. In addition, as charges are estimated in advance, investors bear the risk of the actual charges being different from that estimated by the fund manager in advance. Investors currently bear this risk, despite having no ability to control any differences between the estimated and actual charges taken from the fund.

10.17 These issues are likely to contribute to limited price competition for actively managed funds and asset managers being less effective at controlling complex costs.

10.18 To address these concerns, we are considering introducing a single charge to increase the visibility of all charges taken from the fund and impose more discipline on overspend relative to charging estimates. A single charge could work in four ways:

- **A: The current OCF becomes the actual charge that is taken from the fund.** Under this option, asset managers would have to cover any variation between the OCF, which is currently an estimate, and the actual ongoing charges currently taken from the fund. Under this option, transaction costs (stamp duty, dealing commissions paid to stockbrokers and the 'bid-offer spread') and other charges not currently included in the estimated OCF would not be included in the single charge taken from the fund. This option would require the least change from the current way of deducting charges.

- **B: The current OCF becomes the actual charge, with managers providing an estimate of any implicit and explicit transaction costs.** This would be similar to A, above, but would oblige asset managers to provide an estimate of the transaction costs the fund will incur. This option would enable easier comparison of the likely total charges across different funds.

- **C: There is a single charge which includes all charges taken from the fund, including both implicit and explicit transaction costs, but with an option for 'overspend'.** Under this option, the single charge would cover all costs, although in order to compensate asset managers for trades in exceptional circumstances, managers could have discretion to take additional transaction charges from the fund which would then be clearly explained to investors in the annual statement.

- **D: There is a single charge which includes all charges taken from the fund, with no option for overspend.** Under this option, the asset manager would be bound by the single charge figure and pay any additional investment-related or administrative expenses occurred (including transaction costs). Under this option, the asset manager would bear all the risk of a difference between forecast and actual trading costs.

10.19 We recognise that there are potential benefits to investors for a single charge, but that this proposal transfers elements of risk to the fund manager. We welcome views on how we should assess this trade-off.

10.20 Some asset managers may respond by increasing the single charge to cover the increased risk that their costs will be greater than the single charge. They may also decide to trade less than is in investors' best interests. We would welcome feedback on the extent to which competition will provide enough pressure to prevent a single charge resulting in an increase in charges paid by investors or other unintended consequences such as sub-optimal levels of trading or changes to market practices, particularly given our additional proposed remedies to improve competition. We would also welcome feedback on whether imposing requirements for fund governance bodies would mitigate these concerns.

10.21 We could also change our rules to ensure that any risk-free box profits from the matching of flows in and out of dual priced funds are used solely for the benefit of the fund, and cannot accrue to the asset manager.

Questions for feedback

We would welcome views on:

- The likely effectiveness and proportionality of the:
  - single charge remedy to incentivise asset managers to control the charges taken from funds
  - the specific options (A, B, C, D) set out above
- Any unintended consequences of:
  - single charge remedy to incentivise asset managers to control the charges taken from funds
  - the specific options (A, B, C, D) set out above
  - and how we can overcome any of these unintended consequences
- Do you think that the scope of this remedy should be limited to retail investors or should it be extended to other types of investors?
- Whether there are better alternative remedies or pricing models that would encourage asset managers to control the charges taken from funds?
- Do you agree that risk-free box profits should be used solely for the benefit of the fund and not be permitted to accrue to the asset manager?

Measures to help retail investors identify which fund is right for them

10.22 As we outline in Chapters 4 and 6, we have found:

- It is difficult for more engaged investors to know what to expect from their fund and to assess whether or not it is performing against relevant objectives, including those set by the fund manager.
- Academic studies suggest that some investors do not switch away from funds with long term underperformance. Our initial analysis of UK equity data shows some persistent poor performance and that a large number of poorly performing funds are merged or closed. We propose to do further work between the interim and final report to explore what happens to merged funds, and outline options should we find evidence of persistent underperformance in paragraph 10.28 below.

10.23 For investors who want to scrutinise more closely the performance of their asset manager, we are considering:

- requiring fund managers to set clearer and more specific fund objectives
- providing a timeframe over which performance should be assessed

- providing information which allows investors to assess whether performance objectives are being met, including disclosing managers' benchmarks
- requiring managers to explain the performance of funds that have merged/closed

10.24 To help ensure that asset managers use relevant benchmarks to illustrate performance, we could set out our expectations about how fund managers should use benchmarks to illustrate fund performance and performance against objectives. Managers could then track performance against the objectives they have set out to help investors assess whether returns are reasonable and in line with expectations. We consider the remedy could work for funds seeking to outperform a benchmark, control volatility and/or deliver absolute returns.

10.25 This remedy could be combined with the options set out below which aim to provide clearer charging information to current investors and the single charge remedy discussed above.

10.26 We welcome feedback on the merits of requiring fund managers to set clearer and more specific fund objectives, provide a timeframe over which performance should be assessed, and give investors information which allows them to assess whether performance objectives are being met.

10.27 One risk is that investors consider more explicit objectives to guarantee future returns, and will potentially believe that funds with comparable objectives also have a comparable strategy. However, our current view is that this risk will be managed as long as appropriate measures of risk are given alongside the clearer objectives.

10.28 If our further work suggests there is pattern of persistent underperformance in the UK market, there are a range of potential remedies to help investors consider whether to switch away from funds that persistently underperform. These include:

- the FCA 'shining a light' on funds with long-term underperformance
- asset managers being required to be more explicit and pro-active in their ongoing communications, telling investors when their funds are underperforming relative to the fund's objectives
- asset managers being required to compare performance to a relevant benchmark

Questions for feedback

We would welcome feedback on the following questions:

- Would it be proportionate and effective to require fund managers to be more specific with investors by clarifying an upfront objective and tracking performance against that objective over an appropriate time period?
- How should fund managers and other market players communicate to allow investors to judge success over an appropriate time period? In what circumstances would it be appropriate to provide comparators, for example, performance of passive funds in the relevant market?
- Should we set out our expectations on using benchmarks, particularly when benchmarks are used to trigger performance fees?
- Should managers be required to take action when funds are persistently underperforming and, if so, what form should this action take?
- Is there a role for the regulator in 'shining a light' on poorly performing funds and if so what form could this take?
- Are there likely to be any unintended consequences and, if so, how could they be overcome?
- Are there other metrics/indications/pieces of information that could give investors better insight into likely future returns?

Making it easier for retail investors to move into better value share classes

10.29 As we outline in Chapter 9, firms told us that where they create new share classes (typically in response to RDR), they find it difficult to switch investors to these new, cheaper share classes even if this would be in the best interests of the existing investors.

10.30 There are a number of reasons why investors might remain in a share class despite a cheaper alternative being available:

Figure 10.1: Reasons for being in a more expensive share class

1) Investors are in a pre-RDR share class which is more expensive because they continue to pay trail commission
2) Investors are in a pre-RDR share class which is more expensive but the manager has 'turned off' trail commission
3) Investors are in a more expensive share class than others available through alternative distribution channels
4) The fund manager has launched a cheaper share class (but not for the reasons listed above) which would be available without switching distribution channel. This could be because an investor bought units in a legacy share class and subsequently a cheaper share class was launched. Alternatively, multiple share classes could have been distributed at the same time and the investor ended up in a more expensive one

10.31 Given that investors may remain in higher charging legacy share classes for a range of different reasons, we think any remedies to enable investors to move to cheaper share classes would need to be targeted to the following scenarios:

- **Investors in more expensive pre-RDR share classes, but where commission payments have been turned off:** we would like to explore ways to enable moving from expensive to better value share classes. Options include:
  - 'shining a light' on differences between old and new share classes;
  - experimenting with different communications to test their effectiveness in encouraging investors to switch share class
  - making it easier for asset managers to bulk transfer investors to alternative share classes, where it is in their best interests.

  We think that these suggestions could also apply to scenario 4 in Figure 10.1

- **Investors in more expensive pre-RDR share classes which continue to pay trail commission** we do not currently intend to revisit allowing asset management firms to continue paying trail commission to advisers. However, we would like to explore how best to raise investor awareness of the existence of trail commission and the possibility that they could be better off switching share class (recognising that this might not always be the case).

10.32 As described above, some investors may be in different priced shareclasses in the same fund because they entered the fund through different distribution channels. Being able to negotiate discounts on shareclass charges is an important mechanism distributors can use to encourage competition between asset managers. However, should we take forward further work on retail distribution, one potential issue is whether consumers are able to easily identify the cheapest route to accessing funds.

Questions for feedback

- Do you agree that the focus of any remedies in this area should be on investors in scenarios 2 and 4 outlined above?
- What would be the most proportionate and effective way of moving investors into cheaper share classes? Can you provide an estimate of the cost of moving investors to cheaper shareclasses and how these costs would arise?
- Are there any potential unintended consequences of remedies in this area?

Requiring clearer communication of fund charges and their impact at the point of sale and in ongoing communication to retail investors

10.33 The potential remedies outlined above would aim to make all charges taken from the fund more visible and impose more discipline on overspend against estimates. While these remedies would help to ensure investors see a more comprehensive charge before they invest, we may need to introduce additional remedies to proactively encourage investors to focus on the impact charges have on their investments and enable price comparison.

10.34 The options we would like feedback on are:

A: Making greater use of pounds and pence charging figures in 'point of sale' documentation.

10.35 Currently UCITS managers are required to present an Ongoing Charges Figure (OCF) to investors as an estimated percentage of the total assets under management. However, we have found that investors are better able to understand charges when they are presented in £ amounts. PRIIPs is due to apply to UCITS and NURS. Firms will be required to provide investors with an estimate of charges they may incur in pound amounts (£s).[364]

10.36 These regulatory developments will give investors charging information in a format that is easier to understand. Nevertheless, we found that only 25% of non-advised retail investors reported looking at the KIID when choosing their fund. We think there is scope for other information sources, including fund managers' literature and information from third parties (advisers and platforms), to make greater use of pounds and pence charging information to help investors understand the cumulative impact of charges on their returns.

10.37 We would like feedback on how and where a £ cost estimate could be used most effectively. In order to increase investors' and asset managers' focus on charges, this remedy could be combined with the 'single charge' remedy in paragraph 10.18 above.

B. Illustrating the impact of charges in 'ongoing' communication documents

10.38 Currently, the information provided to investors once they have chosen an investment product varies between different providers. As set out in Chapter 4, it is difficult for some investors to know the impact that charges have had on their returns and so assess if their product offers value for money on an ongoing basis. Some investors are also not aware that they are paying fund charges, which may be the result of poor ongoing communication from their provider.

10.39 We think there is scope for fund managers to explain more clearly the impact charges have had on gross returns, so that investors know how much they are paying for their investments on an ongoing basis. We would like feedback on the form that such ongoing communication could take and any implementation challenges.

10.40 It is also currently difficult for investors to get information about the total costs of their investment, including distribution and advice fees, and to compare the total cost of investing through different routes. The share of distribution and asset management charges varies depending on investors' investment route, size of pot and choice of fund. Therefore, to fully understand the impact of charges on investment returns it is important that investors can get information about the total cost of investment. We would like feedback on how information about the total cost of investment could be provided to investors before they invest (See Figure 10.2 option A+) and after they have invested (See figure 10.2 option B +).

Figure 10.2: the potential scope of measures which enable investor to scrutinise charges

	Point of sale disclosure	Ongoing disclosure
Fund charges	Option A	Option B
Total cost of distribution	Option A+	Option B +

364 The European Commission has announced it will extend the application date of the PRIIPs Regulation by one year. Its expectation is that the revised PRIIPs framework should be in place during the first half of 2017 and apply as of 1 January 2018.

10.41 We propose that any of these possible remedies would apply to all investment vehicles available to UK retail investors, including UCITS, NURS, listed funds, insurance investments and investment trusts.[365] Institutional investors can also invest in these funds and so could also benefit from clearer information about fund charges.

10.42 A more radical option would be to require investors to pay separately for their fund charges, for example, by setting up a direct debit with the asset manager. We do not currently intend to take this forward. However, we are open to feedback on this view.

10.43 We would like to hear from stakeholders about alternative proposals which would encourage retail investors to take asset management charges into account, both before they make their investment decisions and on an ongoing basis. We would also like to hear from firms who would be interested in working with us to explore how to communicate with investors most effectively.

10.44 We are aware of the potential limitations of disclosure remedies, and the fact that not all investors will make use of such information. In our Smarter Consumer Communications initiative, we have seen that retail investors' decision-making can be improved if firms provide information in a way that is engaging, comprehensible and given through appropriate channels at appropriate times. We recognise that investors are using new communication technologies, leading to fast-changing habits and preferences. In light of these insights, we welcome your view on how best disclosure remedies should be designed to achieve their intended purposes.

Questions for feedback

- What is the likely effectiveness and proportionality of:
  - remedies which aim to introduce further cost transparency and aim to encourage retail investors and their advisers to become more price sensitive
  - the specific options (A, B, A+ and B+) set out above and alternative remedies that could be introduced
- What would be the most effective format and mechanism to increase investor awareness of the impact of charges?
- Would there be unintended consequences of:
  - remedies which aim to make investors more price sensitive and, if so, are there ways in which unintended consequences could be overcome?
  - the specific options (A, B, A+ and B+) above and ways in which we could overcome any unintended consequences?
- Are there better alternative options that would encourage investors to become more price sensitive?
- What funds should be in scope of any remedies which encourage greater focus on charges?
- What would be the most effective ways to communicate with investors?

365 A limited company whose business is the investment of shareholders' funds, the shares being traded like those of any other public company.

Requiring increased transparency and standardisation of costs and charges information for institutional investors

10.45 As we outline in Chapter 4, we have found that:

- It has been difficult for pension trustees to get information on transaction costs. As we are currently consulting on how transaction costs should be disclosed to trustees and Independent Governance Committees, we do not consider further remedies are needed to make transaction costs transparent to trustees.
- For segregated mandates there is no consistent definition of the annual management charge with managers including different items within this charge, although trustees could request for charges to disclosed in a comparable format as part of the tendering process.
- Information about charges is often unclear for those investing through more complex fund structures such as hedge funds and private equity funds. Although private equity funds were not in scope of our market study we heard comments that this is a particularly opaque part of the asset management sector, and we will consider whether any remedies should apply in this part of the sector.

10.46 These issues are likely to contribute to asset managers being less effective at controlling complex costs, as well as limiting institutional investors' ability to drive competition and get value for money.

10.47 We recognise that there are industry-led attempts to develop greater cost transparency for institutional investors. For example, the Investment Association is developing a disclosure framework for investment costs which aims to create a standardised fully Comprehensive Disclosure Code for asset managers to disclose investment costs.[366] We support the asset management industry continuing to work together with investor organisations to develop a standardised template to disclosure of asset management-related fees and charges.

10.48 In doing so, we could work with industry to set out our expectations about what the standardised template would cover. Our expectations could include the disclosure to be a minimum which is provided to all institutional investors as standard (allowing scope for further cost information to be provided), and for the template to build on the outcome of our current consultation on transaction costs.[367] In addition we could set out our expectations about the scope of the disclosure template, which could include products used by institutional investors, including pooled funds and segregated mandates and including hedge funds, fund of funds and multi-manager products. We welcome views on whether private equity managers and strategies should be included within the scope of this as well.

10.49 To reinforce the use of the template we could compel asset managers to provide this information and/or to enable comparison, we could recommend and require pension schemes to publish standardised performance and charges information. Both trustees and IGCs are currently encouraged to report cost information in as full a way as possible to scheme members. We could build on these requirements so that trustees and IGCs have to publically report on an

366 For more information about the Investment Association's work and how it is being overseeing please see here: www.theinvestmentassociation.org/media-centre/press-releases/2016/independent-panel-to-advise-ia-on-next-generation-disclosure-for-investment-costs.html

367 www.fca.org.uk/publications/consultation-papers/cp16-30-transaction-cost-disclosure-workplace-pensions

annual basis using a prescribed template.[368] We could also recommend require DB schemes to include this information as part of their annual report. We welcome views on the merits and feasibility of such an approach.[369]

10.50 We recognise that there are risks with publishing charging information, including the risk that it provides a focal point and softens price competition. We welcome views on this point.

10.51 Between the interim and final report we will work with industry and investors groups to ensure the templates give investors the information needed. If we find industry-led initiatives are not likely to be successful or sufficiently comprehensive, we will consider the need for further regulatory intervention.

Questions for feedback

We would like views on:

- Whether institutional investors would benefit from standardised disclosure of asset management fees and charges?
- What fees and charges information should be included in a standardised disclosure framework?
- What would be the cost to asset managers of providing information?
- Would there be unintended consequences if trustees were required to publish costs and charges?
- The scope of fund/products that this disclosure template should cover? Should it cover private equity strategies and hedge funds as well?

Measures to improve the usefulness and comparability of performance information used by trustees

10.52 As we outline in Chapter 4, we found that information presented to trustees about the performance of their investments is often presented in a format that is difficult for investors to understand and engage with.

368 From April 2016 trust-based DC schemes are required to disclose in Annual Chair's Statement the costs and charges (including transaction costs) incurred by the scheme which relate to the default arrangement and other arrangements. For contract-based schemes, the FCA guidance states that pension scheme providers' use their best endeavours to obtain and provide IGCs with information on the costs incurred in managing and investing the scheme's assets, including transaction costs, to help IGC properly assess value for money (COBS 19.5.8G(5)).

369 Please see annex 9 for how similar reforms have worked in the Netherlands

10.53 We encourage industry to consider the best format for presenting performance information to trustees and IGCs consisting of a mix of lay and expert members.

Questions for feedback

- Are there better ways in which information could be presented to trustees, particularly member nominated trustees, in order for them to assess the performance of their scheme? How could this be achieved?
- What format should simplified and comparable disclosure take and who should be responsible for providing the information?

Exploring the potential benefits of greater pooling of pension scheme assets

10.54 As we outlined in Chapter 4, we found that smaller occupational pension schemes are less likely to be able exert pressure on asset managers as:

- there is some relationship between size and investment expertise and resources, with smaller pension schemes generally having fewer resources for governance and monitoring the performance of their asset managers and advisers.
- larger pension schemes are more attractive to asset managers, allowing trustees to negotiate lower fees per pound under administration.

10.55 While there may be benefits from pooling occupational pension scheme assets together to allow schemes to benefit from scale, we recognise that there are likely to be challenges in doing so, including challenges of merging schemes with different liabilities. As a result, we would welcome feedback on whether there are ways that DB trust, DC trust and DC contract based schemes could more effectively pool assets together.

Questions for feedback

- Are there ways in which parts of the institutional demand side (DB trust, DC trust and DC contract based schemes) could more effectively pool assets together?
- To what extent would pooling result in better outcomes for investors?
- Are there logistical challenges involved in pooling assets? How could we overcome these?

Requiring greater and clearer disclosure of fiduciary management fees and performance

10.56 As we outline in Chapter 8, pension trustees find it difficult to scrutinise the performance of their fiduciary manager because:

- There is very little public reporting and scrutiny of fiduciary management fees and performance. This makes it difficult for investors to assess the performance of fiduciary managers and compare them with each other, both at the point of sale and on an ongoing basis.
- Fees and charges disclosure by fiduciary managers is not consistent and comparable.

10.57 The lack of transparency is likely to make it difficult for pension trustees to manage conflicts of interest when investment consultants also provide fiduciary management, leading to poor outcomes.

10.58 We are therefore seeking views on ways to improve the scrutiny of fiduciary management services. While investment consultants providing asset allocation advice to institutional investors does not come under our regulatory perimeter, we authorise and regulate the investment management part of investment consultants acting as fiduciary managers.

Questions for consultation

We would like views on:

- Ways to provide trustees with clearer information about the charges and performance of fiduciary management.
- What information on fees and performance information should be made public and are there ways to benchmark the performance of fiduciary managers?
- What are the unintended consequences of enhanced disclosure and how can we overcome them?
- What is the likely effectiveness and proportionality of guidance to trustees on these issues?
- Are there better alternative remedies that we can put in place to empower trustees in their decision making?
- What could any guidance from TPR/FCA to trustees in this area usefully cover?

Consultation on whether to make a market investigation reference to the CMA on the institutional advice market and bring the provision of this advice with the FCA's regulatory perimeter.

10.59 The strategic investment advice provided by investment consultants helps determine a pension scheme's asset allocation.

10.60 Asset allocation is likely to be a crucial determining factor in long term investment performance and is an important way in which consultants can add value for their clients. However, we found that there is very limited scrutiny of the asset allocation advice given by investment consultants. The quality of this advice in terms of the returns it generated or the value-added is not measured or monitored in any consistent and comparable way.

10.61 We recognise that measuring asset allocation advice can be difficult for the following reasons:

- Schemes or other clients have a bespoke benchmark or target they want to achieve, with varying underlying assets and liabilities, which determines the advice. This makes it difficult to compare the quality of advice given to different schemes or clients.
- The performance of the advice has to be measured over an appropriate time period. Schemes design their funding plans to match assets and liabilities over a ten, fifteen, or an even longer time period, which varies across schemes. The target period plays a role in the asset allocation. This means that the performance of the advice needs to be considered over the appropriate period to see whether it has achieved its target. As different schemes

have varying time periods, this also makes it difficult to compare the quality of advice across schemes.

- The discretion that consultants have in setting the asset allocation strategy varies. In some instances they only make a recommendation and the trustees make the final decision. In others, institutional investors rely on their advice completely. Without knowing who is responsible for setting the asset allocation, it is hard to identify the impact that advisers have on the performance of the scheme.

10.62 Despite this, it is possible to have some performance measurement for asset allocation advice. In some RFPs, where clients ask for asset allocation information, consultants have provided performance information which gives clients some measure of what results the consultant's asset allocation advice has helped the client achieve. However this information was not calculated according to a standardised methodology which makes comparison difficult.

10.63 We consider that the limited scrutiny of asset allocation advice can result in institutional investors focusing on more tangible aspects of their role instead of engaging with asset allocation which is likely to have the biggest impact on returns. There may also be limited competition over the quality of the advice which ultimately might affect returns for institutional investors. We believe the market for investment consultancy services would benefit from a market investigation reference (MIR). The CMA would be best placed to explore what impact the difficulties in assessing the quality of investment consultancy advice has on competition between investment consultants, the advice they offer and ultimately the returns investors receive.

10.64 The asset allocation advice provided by investment consultants and employee benefit consultants is not regulated by the FCA. This means that we are not able to set performance standards or assessment criteria for this advice. We also have limited authority to ask industry to develop ways to measure and assess advice themselves. This is one of the factors we considered when determining whether to make an MIR.

10.65 In addition to our provisional decision to make an MIR, we are considering recommending that HM Treasury brings the provision of this advice within the regulatory perimeter. This is a very important part of the asset management value chain which is currently unregulated. Bringing this within our regulatory ambit would not only improve regulatory oversight on this activity, it would also mean we would be in a position to take forward any recommendations put forward by the CMA's market investigation reference.

10.66 We set out our reasons for consulting on a potential Market Investigation Reference in more detail in the provisional decision document published alongside this interim report[370]. The date for responding to the consultation on the provisional decision to refer is 20th February 2017. We welcome representation from all interested parties on the topics raised in this consultation document. In addition to comments and views, we are asking you to provide evidence to support your answers where possible.

370 Entitled 'provisional decision to make a market investigation

Questions for feedback

We would like your comments on our provisional decision to make an MIR. Please see the publication which sits alongside this report and sets out our consultation questions and the period within which to respond.

We would also like views on:

- Whether the FCA should recommend that HM Treasury brings the provision of advice provided by investment consultants to institutional investors within the regulatory perimeter
- Whether to bring the provision of advice provided by employee benefit consultants to employers and trustee boards within the regulatory perimeter
- Are there alternative remedies that we should also consider to allow better monitoring and assessment of advice provided by investment consultants and employee benefit consultants

Further FCA work on distribution in the retail market

10.67 While distribution in the retail sector was not wholly in scope of the asset management market study, a number of respondents suggested the way in which asset management services and products are distributed to retail investors may mean they get poor value for money. These concerns were:

- the transparency of distribution charges may make it difficult for investors to understand the total cost of investment
- the investment services offered by distributors may not offer value for money, particularly as the charges may not be transparent and distributors may face conflicts of interest which result in poor quality products
- the third party rating providers' business model may result in investors and advisers not being able to access information that helps them assess investment products
- the timely transfer between platforms may be an impediment to competition

10.68 We are considering whether to take forward further work in this area, outside the asset management market study.

11.
Next Steps

Further work planned

11.1 We will continue to develop our thinking on whether we should intervene in this market, and what interventions would be most effective in improving competition to the benefit of investors. We will have regard to the further evidence we collect and responses of stakeholders.

Final report

11.2 We expect to publish our final report in 2017. The final report will set out our findings and conclusions. If appropriate, we will consult at the same time, or subsequently, on any proposed actions.

Stakeholder views

11.3 We would like to hear your views on this report, including your views on the questions set out in Chapter 10 on the need for intervention and what form it should take. Please send us written comments by 20 February 2017.

11.4 If you would like to email feedback, please contact us at **assetmanagementmarketstudy@fca.org.uk**.

Glossary of terms used in this document

Absolute return funds	These funds aim to deliver a positive return in any market condition, but returns are not guaranteed. Usually the target return is expressed with reference to a cash benchmark (eg LIBOR) over a specific time period.
Active management	The manager aims to achieve a specific result, such as beating the performance of a benchmark index, by actively making decisions when investing in particular markets, sectors or securities. When we refer to active funds in this document this includes all investment strategies which are not following a passive investment strategy.
Ad valorem fee	A fee structured as a fixed percentage of the assessed value of the assets being managed. It means 'according to value'.
Adviser platforms	Online services used mainly by intermediaries to view and administer investments on behalf of advised retail customers.
Ancillary service providers	Third party firms which provide services to help operate a fund or support an investment mandate.
Asset allocation	Allocating different proportions of an investment portfolio to a mix of different asset classes (eg equities, fixed income, cash). These allocations are intended to help investors achieve their investment objectives in line with their risk tolerance and over a certain time period.
Asset class	A group of securities which share similar characteristics and are subject to similar laws and regulatory requirements. Asset classes include equities, fixed income and cash.
Automatic enrolment	A legal requirement that all employers must automatically enrol their workers into a qualifying pension scheme.
Back office	The part of a firm which is not client- facing. It and often includes administration and support functions.

Barrier to entry	A specific feature of a market that gives incumbent firms advantages over potential competitors.
Benchmark	A standard against which the performance of an investment product can be compared. For example, a benchmark could be the performance of the market index, or the performance of a peer group of products.
Best buy lists	A list of funds which Direct-to-Consumer platforms offer as their view of the 'best' funds available to investors in a particular sector and/or asset class.
Bid-offer spread	The difference between the bid (the highest price a buyer is willing to pay) and offer (the lowest price the seller is willing to accept).
Box profits	In some funds there is a difference between the price to buy units in the fund and the price to sell them. This is used to cover the cost of buying or selling the underlying securities. When the asset manager can match up investors to buy and sell units they do not incur a cost of trading the underlying securities, but the manager can still keep the difference, which is called a (risk-free) box profit.
Bundle	Buying more than one product or service from the same provider and paying one combined, sometimes discounted, fee for the whole package.
Churn	Unnecessary trading which is largely undertaken to generate commissions or fees, rather than produce a return for the client.
Contract-based scheme	A pension scheme bought by an individual, often through their employer, and managed by a third party pension provider. It is owned entirely by the individual and the contract is between the individual and the pension provider.
Custody charges	The fee paid to custody banks to look after money on behalf of asset managers or their clients. The charge is usually passed onto the investor.
Defined Benefit scheme	A trust-based pension scheme in which the benefits are defined in the scheme rules and accrue regardless of the contributions that are paid and the investment returns. The benefits are usually a proportion of the member's salary when they retired and are related to the length of their pensionable employment.
Defined Contribution scheme	A scheme in which a member's benefits depend on the value of their total pot. The pot, in turn, depends on the amount of contributions the member paid into it, and any investment returns net of charges.

Dilution levy	A fee asset managers charge for large purchases or redemptions in a fund to reduce the diluting effect of the transaction costs on the returns of investors who stay in the fund. The Authorised Fund Manager decides the amount or rate.
Distributed ledger technology	Records of electronic transactions that can be shared across a network.
Downside risk	The financial risk of losses.
Econometric analysis	Applying statistical techniques to assess economic problems.
Economies of scale	A cost advantage that occurs as output levels increase.
Enhanced index	Funds which share similar characteristics with passive funds, although still have an element of active management
Execution quality	How well an asset manager trades on behalf of their investors, taking into account where and when they trade.
Factor overlays	Certain characteristics or 'factors' that can explain securities' historical risks and returns (for example volatility, fundamentals and momentum). These factors are then applied to or 'overlaid' on an existing investment strategy.
Factor-based investment strategies	Strategies that align investments to factors which have historically been able to explain improved risk-adjusted performance.
Fiduciary management	This is an industry term with no set definition. Usually taken to describe cases where a service provider advises clients on how to invest their assets and then makes investments on behalf of the client for all or some of their assets as well. These delegated responsibilities can include selecting asset manager and strategic asset allocation. This is sometimes also called implemented consulting.
Financial advisers	Those who offer personal investment advice to retail investors.
Fund of funds	A fund which holds a portfolio of other investment funds rather than investing directly in stocks, bonds or other securities.
Fund operator	This could be the Authorised Fund Manager, Authorised Corporate Director or the person appointed or responsible for managing of the property held for, or within, a scheme. For the full regulatory definition see the FCA Handbook.
Host Authorised Corporate Director	An independent third party (ie non-group entity) appointed to act as an Authorised Corporate Director for an Open-ended Investment Company (OEIC).
Hurdle rate	The minimum rate of return a firm expects to earn when investing in a project.

Implicit and explicit transaction cost	The cost to buy and sell securities. These costs could be a direct charge ('explicit' cost) or could be reflected in the price of the security ('implicit' cost).
Index tracker	See 'Passive'.
Information Ratio	A measure of excess returns over and above a benchmark.
Institutional investor	An investing legal entity which pools money from various sources to make investments.
Mandate	A list of restrictions or permissions from the investor about how assets can be invested.
Master trust	A single occupational trust-based pension scheme established by a trust agreement. This is set up to provide benefits to members from different employers (no individual employer group has a separate section with its' own trustees).
Mixed bundle	When parts of a bundle can either be bought individually or as part of a bundle.
Model portfolio	A selection of investments designed by firms as 'off the shelf' solutions to meet different risk profiles and investment objectives.
Most Favoured Nation clause	A 'Most Favoured Nation' clause entitles a customer to obtain the most-favourable terms that a supplier offers to any other customer[1].
Multi-asset fund	A fund that includes several asset classes, for example bonds and equity, rather than just one asset class. This kind of fund is often created with the intention of adding diversification. They have also been known as balanced or diversified growth funds.
Multi-manager funds	An investment portfolio's assets are allocated among several fund managers.
Net flow of / into funds	Net flow of funds is the value of all cash flows into a fund minus all cash flows leaving it, measured over a specific time period.
Net performance	Investment return after fees.
Networks (financial advisers)	Firms with 5 or more appointed representative firms, or with appointed representatives who have 26 or more individual advisers between them.
Passive management	Strategies which seek to mimic the performance of an index using a systematic process to replicate it.
Pay to play model	Where the users of an intermediary's services do not pay for the service, but instead the intermediary charges providers.

1 (R. Wish and D. Bailey Competition Law, Oxford University Press, 2015, p. 688.)

Pension freedoms	A package of reforms to the retirement market announced in the Budget 2014 and introduced in April 2015. These reforms give consumers greater freedom over how to generate a retirement income from their pension savings.
Platform	A service that gives investors access to a range of funds managed by different asset managers, typically online.
Pooled funds	Funds where money from different investors is pooled and managed together.
Price dispersion	A measure of the variation of prices across sellers of the same service at one point in time.
Pure bundle	Goods or services which can only be bought together and which cannot be bought separately.
Replicate the market	Where a portfolio is constructed either in full or using sampling techniques to generate returns equivalent to those of the market.
Request to transfer title	Where a firm or a third party holds a title to a retail investment product on a clients' behalf, and the client asks for the title to be legally transferred to another person. See Handbook COBS 6.1 G.
Retail investors	For the purpose of this document this includes all non-institutional investors.
Returns to scale	The quantitative change in output of a firm or fund in response to a proportionate increase in all inputs. For example, if a fund exhibits decreasing returns to scale, this would describe a situation where generating returns for investors becomes less efficient as assets under management become larger.
Risk-adjusted net returns	A correction to the return (after fees) which reflects how much risk has been taken in order to produce that return.
Segregated mandate	A fund that is run exclusively for one (institutional) investor.
Smart Beta	There is no common definition or underlying composition methodology. Broadly these strategies aim to deliver a better risk and return trade-off than conventional passive funds by using alternative weighting based on measures such as volatility or dividends.
Solutions	A combination of products and/or services delivered as part of one package to investors, often to achieve a pre-defined investment outcome.

Survivorship bias	The tendency for investment products (or firms) to close (or exit the market) following poor performance. If closed investment products (or firms) are not included in estimates of an industry's aggregate returns then returns will be overestimated. This overestimate is known as survivorship bias.
Swing price	This is an adjustment to the fund's Net Asset Value based on net cash inflows/outflows. The swing price intends to protect existing fund investors from the diluting effect of transaction costs that arise as a result of investors entering or leaving the fund.
Tied agent	An agent for the purposes of section 39A of the Financial Services and Markets Act 2000.
Tracking difference	The difference between the investment return generated by a fund and the market return.
Tracking error	Compares the variance of returns of the portfolio with the variance of the market.
Transaction costs	Costs incurred in connection with transactions (trades) undertaken for a portfolio.
Trust-based scheme	A pension scheme which is generally run and managed by an employer through a board of trustees.
Trustees	People or a company acting separately from the employer, that hold assets in trust for beneficiaries.
Value Chain	All the goods and services which contribute to the provision of asset management in the UK.
Vertical integration	When one group provides a client with a range of different services or products at different levels in a supply chain (for example manufacturing and distribution).
Wrapper (tax)	Products such as SIPPs and ISAs which allow investors to invest in other underlying investment products in a tax-efficient manner.

Financial Conduct Authority

PUB REF: 005324

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