Financial Conduct Authority

Thematic Review

TR16/3

Meeting investors' expectations

April 2016

Contents

Abbreviations used in this paper

AMC	Annual Management Charge
COBS	The Conduct of Business sourcebook
FTSE 100	The Financial Times Stock Exchange 100 Index
KIID	Key Investor Information Document
RPPD	The Responsibilities of Product Providers and Distributors for the Fair Treatment of Customers
UCITS	Undertakings for Collective Investments in Transferable Securities

1. Executive summary

Overview

1.1 In the fund management sector, firms should act as agents that compete to provide returns and services that are consistent with an investor's objectives. This work considers how firms ensure they meet investors' expectations.

1.2 The UK fund industry plays a vital role in delivering financial investment services to customers. Firms in this industry manage UK domiciled funds worth more than £800 billion on behalf of institutional and retail investors.

1.3 The Meeting Investors' Expectations thematic review considered whether UK authorised investment funds and segregated mandates were operated in line with investors' expectations as set by marketing material, disclosure material and investment mandates. We also considered how firms monitored the appropriate distribution of their funds.

1.4 The thematic review covered 19 UK fund management firms responsible for 23 UK authorised funds and four segregated mandates. All of the funds were available to retail investors and followed active investment strategies.

Key messages

1.5 Overall, we found that fund management firms are taking the right steps to meet investors' expectations and comply with their responsibilities towards investors.

1.6 It is important that fund management firms ensure that product descriptions are clear and correct because investors and financial advisers decide whether to invest in authorised investment funds based on this information. This includes disclosing if funds have a strategy based on an index and if the investment manager's flexibility to invest differently from that index is limited[1].

1.7 Fund management firms must provide effective governance and oversight throughout the whole of a fund's life, including funds that are no longer actively marketed[2].

1.8 Fund management firms need to identify trends that may indicate inappropriate sales by monitoring the distribution channels they select as part of their responsibilities as product providers[3].

1 COBS 4.2.1R, COBS 4.13.2R, COLL 4.2.5R, COLL 4.7.2R, Key Investor Information Regulation article 7.1, The Responsibilities of Product Providers and Distributors for the Fair Treatment of Customers (RPPD) 1.18 and 1.19

2 Principles for businesses 2, 3 and 6, COLL 6.6.3R, RPPD 1.17

3 RPPD 1.20

1.9 Distributors should ensure that they obtain the correct documents from fund management firms so appropriate information can be provided to investors[4].

Findings

1.10 Most funds in our sample invested in line with their stated strategy and investors were not exposed to any undisclosed investment risks. However, we did find some examples of unclear product descriptions and inadequate governance or oversight.

Clarity of product descriptions

1.11 Fund management firms must clearly describe how they manage funds on behalf of investors and the risks of investing in particular funds. This information should be consistent between marketing documents and the fund's disclosure documents (key investor information document and prospectus). Funds that did this well provided investors with a thorough explanation of the fund's investment strategy, as well as specific information about the aims and asset allocation of the fund. Seven out of 23 funds' key investor information documents (KIIDs) did not have clear descriptions of how they were managed. In three of these funds the investment strategy was constrained, with limited freedom in relation to a benchmark. This was not disclosed, meaning customers may not have fully understood the fund. Documents for one fund used jargon that a retail investor is unlikely to have understood.

Providing adequate oversight and governance

1.12 To ensure investors' expectations are met, fund management firms must monitor and review stated investment objectives and take necessary steps if a fund is not being managed in accordance with its objectives. When funds cease to be actively marketed there is a risk that firms do not provide the same level of attention to customers' interests as they do for recently launched products. Our sample included four funds which were not actively marketed and we identified issues in all of them. The investment strategy was not clearly disclosed to customers in any of these funds, and in one case the firm's governance did not ensure the fair treatment of customers.

Ensuring appropriate distribution

1.13 Fund management firms have responsibilities as product providers when distributing funds through third parties. Five firms from our sample of 19 were taking steps to identify trends that could indicate inappropriate sales by ensuring they received and processed relevant sales and customer information from distributors. However, not all firms carefully monitored the distribution of their funds. We found two funds that were available on execution-only platforms when the fund management company had planned for the funds to be only available with advice.

Next steps

1.14 All fund management firms should consider the findings in this paper and review their arrangements accordingly. Distributors should consider their responsibilities in light of our findings.

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1.15 Senior management and those involved in fund governance should consider whether any of the concerns we raise in this report are reflected within their own firm's operations and take any action necessary to minimise the risk of poor outcomes to customers.

1.16 We will shortly be writing to all the firms in our thematic sample to provide individual feedback. Where fund management firms did not effectively manage the risks that could lead to poor customer outcomes, we will require them to make improvements to their practices. For the most significant issues, we are already requiring them to be addressed.

1.17 We will follow up on this work through our routine supervision.

2.
Our approach for the Meeting Investors' Expectations review

What we did in this review

2.1 We selected a sample of funds varying in size with a total value of approximately £50 billion. The funds' strategies ranged from simple to highly complex and the funds invested in a variety of asset classes including equities, derivatives, corporate and government bonds.

2.2 The 23 funds were Undertakings for Collective Investments in Transferable Securities (UCITS) schemes sold to retail investors and 20 of these were available on commonly used execution-only platforms (websites where customers can make their own decision about how to invest without advice).

2.3 We performed a desk-based analysis of portfolio holdings and disclosure documents, and visited the firms responsible for the funds. During these visits we discussed how the fund manager invested the assets on behalf of the fund. We also discussed how investors were considered when designing investor communications and the steps firms had taken to ensure fund documents were clear, accurate and consistent with one another. We assessed the oversight firms had put in place to ensure their investment approach was consistent with the statements in these documents, and how they monitored the distribution of funds.

2.4 Finally, we reviewed four segregated mandates to assess how firms communicated, managed and oversaw these portfolios. The segregated mandates selected were institutional investor portfolios managed by UK fund management firms.

2.5 We decided not to assess a larger number of segregated mandates as the risks associated with communication and delivering on expectations are less prominent than in funds, where oversight is not carried out directly by investors but by the authorised fund manager. The mandates we reviewed were closely overseen by the client through regular reporting and meetings with the asset manager. Clients were also sufficiently knowledgeable, or were provided with advice, to understand the risks inherent in the mandates and address potential concerns.

3. Findings

Clarity of product descriptions

3.1 Clear product descriptions are necessary for investors to understand which strategies funds follow, how fund managers will invest on their behalf, and what risks are involved when investing. Firms need to provide customers with enough detail about a fund in a clear and concise manner that they can understand. Not providing enough information, or using jargon, can limit customers' ability to make informed investment decisions.

3.2 In our sample, firms generally provided adequate information about the funds' strategies, characteristics and inherent risks, enabling customers and financial advisers to make investment decisions on an informed basis. Funds with clear product descriptions gave a thorough explanation of the fund's investment strategy and included elements specifying how the fund manager would invest the fund's assets.

3.3 Seven funds had quantifiable performance targets, enabling investors to easily measure if performance was as expected on an ongoing basis. The funds were either aiming to outperform a commonly known index or had a defined growth target over a specified time period. Seven funds had descriptions of how much of the fund's assets would be invested into various asset types (e.g. that the fund would invest a maximum of 80% of its assets in equities). Clear product descriptions also included specific investment criteria for certain asset types, for example minimum bond credit ratings and an explanation in plain language of what the rating meant. These elements were included in the fund's objective and investment policy, and its KIID in clear language.

3.4 Seven KIIDs did not have clear descriptions of how they were managed. Of these, five funds used a benchmark-related approach that should have been disclosed (also known as closet trackers; see the section on benchmark-related funds below) and one used jargon that a retail investor might not have understood. Finally, one fund's KIID informed investors that currency risk would be hedged by the use of currency contracts. However, active decisions were taken by the fund manager as to whether to hedge some currencies or not. This gave a potentially misleading impression of the level of currency risk in the fund.

Good practice – Detailed explanation of investment strategy
One fund had a thorough explanation of its strategy in its prospectus. The fund's objective and investment policy stated that the manager would select equities based on a detailed fundamental and macroeconomic analysis. It then explained the specific investment steps the manager would usually go through to choose individual equities for the fund's portfolio.

The fund's KIID contained a more concise version of the description in plain English. The firm had involved the fund manager in drafting the description of the strategy - reducing the risk that the actual strategy would deviate from the strategy disclosed to investors. Involving the fund manager also resulted in an appropriate level of detail in the fund's objective and investment policy.

Good practice – Signposting complexity
One firm was responsible for a fund that was highly complex. Marketing material included a strong recommendation for customers to seek advice. This could help mitigate the risk of inappropriate distribution to investors who did not understand all the important aspects of the fund.

Good practice – Being specific about the investments that will be used.
While some firms draft prospectuses broadly, one firm in our sample wanted to be more specific about the instruments used in its fund. Its prospectus described only the instruments that would be used by the fund manager. This contrasted with some other prospectuses that included any instrument that might be used, even if the instrument's use was unlikely.

The firm achieved a more specific prospectus by involving the fund manager in its drafting. It also had a legal team embedded in the business, so the team had a detailed understanding of the funds and their management.

Poor practice – Unclear product descriptions
One fund had a broadly drafted investment policy to invest in companies. It mentioned that the fund may also hold government debt securities and cash. There was no indication about what might cause the fund manager to invest into assets other than companies.

In fact the fund had a flexible investment approach and the fund manager was able shift the fund's allocation between different assets depending on market conditions. A significant proportion of the fund had been invested in government bonds and cash for more than a year.

A broad investment mandate, combined with a lack of description of how a fund manager might use the mandate, could lead to customers investing in funds that have a different asset allocation than they expect. These funds might not be appropriate for their needs.

3.5 A point raised by firms was that investors and financial advisers often used a variety of sources for information when choosing an appropriate fund, including information presented on factsheets and websites. Firms must make sure that the way they present funds is consistent across various sources of information to avoid the risk of customers misunderstanding their product.

Good practice – Accuracy and consistency
Three of the firms in our sample used a similar approach to ensure descriptions were accurate and consistent across all literature. In each firm a person with an in-depth understanding of a particular fund was required to review all new literature related to that fund. Their knowledge ensured accuracy and looking at all literature ensured consistency.

Good practice – Consumer dialogue
Five firms in our sample performed end-customer testing to assess retail investors' understanding of documents. The testing covered their understanding of the characteristics and risks of the funds. Feedback from the testing was used to make the product description easier for the intended audience to understand.

Benchmark-related funds

3.6 Part of our work considered how funds' strategies were constrained by the investment approach and how fund managers disclosed this to investors. An extreme example of this may be a fund that is designed to passively track an index but this is not disclosed to investors. This is often referred to as a 'closet tracker'. There may be good reasons for a fund to perform in a similar way to an index. For example, an active decision to invest closely to an index for a short period to limit the funds risk compared to the index. If a fund is structurally constrained by policy or practice this should be disclosed to investors.

3.7 We found that three actively managed equity funds in our sample were following enhanced index strategies without adequately disclosing this. A fund following an enhanced index strategy uses an index, such as the FTSE 100, as a starting point and is managed to stay within predefined limits in relation to the index. For example, the fund may have a limited outperformance target (e.g. 0.5%) and a limited tracking error (e.g. 2%). This type of strategy limits how far the fund can deviate from the benchmark and so how much risk the fund can take compared to the index. Two of the funds used commercial indices and the third fund used an index the firm had constructed.

3.8 The strategy, indices and degree of freedom the fund manager had in relation to each index were not adequately disclosed to investors. Likewise no indices were included as benchmarks in the past performance section of each fund's KIID. Investors did not know the fund's strategy and were unable to judge the level of risk and return they might get from the fund compared to the index.

3.9 Two other funds had material passive holdings that were not adequately disclosed. Investors in these funds might not have received a clear enough view of the fund's investment approach.

3.10 Funds with benchmark-related strategies must disclose the benchmark and, for active funds, the degree of freedom the fund manager has relative to the benchmark. This information should be disclosed whether public or private benchmarks are used. This enables investors to invest in funds with strategies, risk profiles and levels of active management that are appropriate for their needs.

3.11 If a fund invests a material part of its portfolio passively, this should be disclosed to investors in pre-investment documents.

3.12 Fund management firms should check whether their documents are clear and, if the fund has a strategy related to a benchmark or has invested a material part of its portfolio to track an index, that this is adequately disclosed. Clear and accurate information will allow investors and financial advisors to make informed decisions and judge value for money.

Poor practice – Undisclosed passive investments
Two actively managed funds did not mention in the funds' prospectus, KIID or factsheet documents that as part of the funds' overall strategy, approximately 20% of each fund's assets were passively invested to track an index.

Explaining risks clearly to investors

3.13 Different funds are exposed to different risks depending on the investment strategy used and the assets in which they invest. Investors need to be provided with a clear view of the risks if they are to make an informed choice. Without this information, they might choose an inappropriate fund.

3.14 Most firms disclosed the key risks in their funds. Of the 23 funds we reviewed, there were two examples of funds that did not adequately disclose material risks to investors in the KIID. We also found areas firms could improve to provide clearer risk descriptions.

3.15 Seven KIIDs did not clearly explain the consequences of risks, so investors might not understand how the risks could affect the value of their investment. One KIID included a lot of jargon and investors might not have understood the risks of investing in the fund.

Good practice – Prospectuses that help investors compare risks
One firm included a table in the prospectus setting out the risks to which each fund was exposed. This made it easy for investors to identify the risks relevant to a particular fund and choose investments with appropriate risk profiles.

Good practice – Consistent communication of risks
One firm included material risks in both KIIDs and factsheets. Investors therefore got a consistent view of the fund and its risks across documents.

Providing adequate oversight and governance

3.16 Fund management firms must act in the interests of investors when operating or managing funds. These obligations apply through the life of the fund and should ensure firms deliver products that are in line with investors' expectations.

Portfolio monitoring

3.17 We found firms generally had appropriate controls and monitoring to check asset types and the amount invested in a particular asset or group of assets. Regular reviews assessed the investment approach more broadly to make sure that the agreed investment strategy continued to be used. Firms also monitored the investment return produced, but we found one example where the amount of income provided by an income fund was not monitored.

3.18 Firms should ensure that they monitor all relevant aspects that an investor would expect to be delivered by a fund from their marketing and pre-investment documents.

Good practice – Ensuring fund management matches communications
When performing regular monitoring, one firm compared various aspects of the fund's management against communications. For example, when reviewing the fund's portfolio turnover rate the firm compared this to the long term investment approach they had communicated to investors. This made sure the fund was managed in line with how it had been presented to investors.

Funds not actively marketed

3.19 Firms must monitor funds and treat customers fairly throughout the lifetime of the product irrespective of whether the fund is being actively marketed.

3.20 Most of the funds we reviewed were being actively marketed, but four funds were not. These funds were open to ongoing investment by existing customers, but were not being promoted to new investors. Some investors had been invested in one of these funds for 15 to 20 years.

3.21 In these funds there appeared to be a concentration of issues suggesting that the firms had not overseen them as carefully as the funds that were still being actively marketed.

3.22 We identified oversight issues in all four funds in our sample. Two funds did not disclose that they were taking an enhanced index approach. The other two funds did not disclose that they had a significant part of their portfolio tracking indices (see Benchmark-related funds above).

Poor practice – Inconsistent product review
One firm decided to review the annual management charge (AMC) of two funds following negative publicity. The AMC was reduced, in part because a charge for advice that was included in the fee was no longer necessary. The firm consciously restricted the scope of its internal review and did not review other funds with similar advice charges built into the AMC. This included the fund in our sample which was not actively marketed. Customers in the fund therefore continued to pay a higher AMC, which reduced their return.

Ensuring appropriate distribution

3.23 Investors rarely buy funds directly from fund management firms, but invest through financial advisers or platforms. If a fund management firm has decided that a fund should only be available with advice, it is important that the firm control their distribution channels.

3.24 We found two funds that were available on execution-only platforms when the fund management company had planned for the funds to be only available with advice. The fund management firms responsible for these funds were not aware of this method of access. As they decided that these funds should only be available with advice, there is a risk that investors might have inappropriately invested in these funds.

3.25 Both fund management firms and distributors should ensure that appropriate distribution routes are being used. If necessary, they should have systems that allow the segregation of advised-only and execution-only funds.

Monitoring sales patterns

3.26 Whether customers use advice or not, fund management firms are responsible for checking sales patterns against the fund's target market. This will allow firms to identify unusual patterns that may indicate a problem in distribution leading to inappropriate sales. For example, if significant inflows come from investor types outside the intended target market or a financial adviser is selling the fund to an unexpected investor type. Identifying issues early may allow firms to resolve them quickly.

3.27 We reviewed distribution oversight at 10 firms. Most firms were monitoring sales to identify unexpected patterns among distributors, but two were failing to do this. Five firms were investing in developing smarter ways to analyse data from their distributors to form a deeper understanding of the types of customers that were investing in their funds. This information would allow them to monitor whether funds were reaching the intended target market.

3.28 Firms should consider how to get enough data from distributors to allow them to ensure appropriate distribution of their products.

Good practice – Using indicators to monitor distribution
One firm used specific indicators to monitor unusual patterns in distribution. High levels of cancelled sales and customers selling funds shortly after buying into them were seen as warning signs. The firm was also able to get information on how many customers were in different age brackets, providing some insight into whether the fund was being bought by the planned target market.

Good practice – Interaction with advisers
One firm conducted a considerable amount of due diligence on new financial advisers and provided extensive training to make sure the financial advisers had a good understanding of the investment characteristics and philosophy that was driving the fund's composition.

Another firm trained financial advisers about its complex fund and included a test to assess their understanding of the product.

Providing appropriate information

3.29 Regardless of the route investors take to buy a fund, they need to be provided with the right information. This should be clear, fair and not misleading, and take account of the target audience.

3.30 Some fund management firms produce documents that are designed to be used only by investment professionals, such as financial advisers. It should be made clear that these documents are not for retail investors. If investors are provided with information that is unclear, incomplete or too complex, they may not fully understand the product they are buying and might invest in a fund that does not meet their needs.

3.31 We found three factsheets that did not make clear that they were designed for professional use only. For example, in one case a small disclaimer was included in a large paragraph of small print at the end of the document, but this was not prominent enough. Importantly, two of these documents were available on execution-only retail platforms.

3.32 Both fund management firms and distributors are responsible for information provided to investors. Fund management firms must provide distributors with information appropriate for the type of investors they service. Distributors must exercise due skill and care to make sure the correct information is provided to the intended readers.

Poor practice – Factsheet
One fund's factsheet was clearly labelled 'for professional investors only' at the top of the first page. Nevertheless, it was available for retail investors on two execution-only platforms, as well as the fund management firm's homepage. The factsheet contained information which the firm had only intended to be presented to professional investors.

4.
Next steps

4.1 All fund management firms should consider the findings in this paper and review their arrangements accordingly. Funds should be described clearly and with enough information about the investment strategy for investors to understand the approach used by the fund manager. Relevant risks should be identified and their consequences made clear.

4.2 Authorised fund managers need to oversee funds effectively, even if the fund is no longer being actively promoted to investors. They should also ensure that funds are appropriately distributed.

4.3 Distributors should consider their responsibilities in light of our findings and ensure the appropriate information is provided to investors.

4.4 Senior management and those involved in fund governance should consider whether any of the concerns we raise in this report are reflected within their own firm's operations and take any action necessary to minimise the risk of poor outcomes to customers.

4.5 We will be writing to all the firms in our thematic sample to provide individual feedback. Where fund management firms did not effectively manage the risks that could lead to poor customer outcomes, we will require them to make improvements to their practices. For the most significant issues, we are already requiring them to be addressed.

4.6 We will follow up on this work through our routine supervision.

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