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## Investment costs – more than meets the eye

### Introduction

Millions of individuals in the UK depend on the services of the fund management industry for their long-term financial needs. By investing through a multiple of products<sup>1</sup> that form a superstructure of savings vehicles, individuals are reliant, directly or indirectly, on fund managers to act as stewards of their collective savings.

The importance of fund managers' stewardship continues to grow. Funds managed in the UK by members of the Investment Management Association (IMA) on behalf of overseas and domestic clients grew by 13% last year to reach £5 trillion.<sup>2</sup> Add the activities of non-IMA members and the figure rises to £6 trillion. IMA members managed £4 trillion of assets for institutions, such as workplace pension schemes, and £1 trillion for private, mainly ordinary retail customers. Assets under management in UK-domiciled collective investment schemes - the main retail saving vehicles, authorised by the Financial Conduct Authority (FCA) - grew by 16% to £770 billion, matching the scale of similar funds domiciled overseas, notably in Luxembourg and Dublin, but managed in the UK.

In future years, the continued decline of company final salary schemes and the impact of automatic enrolment mean that many more people, possibly over 12 million by 2018,<sup>3</sup> will be regularly contributing to "defined contribution" (DC) pension schemes, in which the final pension pot depends largely on the level of contributions and net investment returns achieved by asset managers.<sup>4</sup> Also significant is the 2014 Budget, and the related changes, that will give people greater access to their DC pension savings from the age of 55. Many people will need to invest these savings to generate an income in retirement. The Budget also increased the Individual Savings Account (ISA) limit, so people can now invest up to £15,000 a year in a tax-advantaged ISA 'wrapper'. Continued low returns on short-term liquid savings have also increased the need for individuals to secure better returns on long-term investments at appropriate levels of risk.

Individuals are therefore dependent on the asset management industry to deliver good outcomes at an acceptable cost. But the full costs incurred by consumers when making long-term investments are not consistently and comprehensively defined, nor understood. This despite intensive statutory regulation, and attempted reforms by the industry itself. Moreover,

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<sup>1</sup> For example, a pension fund, a unit-linked life insurance policy, a unit trust, an open-ended investment company or a closed-end investment trust.

<sup>2</sup> Investment Management Association (September 2014), "Asset Management in the UK 2013-2014. The IMA Annual Survey".

<sup>3</sup> Pensions Policy Institute (July 2014), "How will automatic enrolment affect pension saving?".

<sup>4</sup> Asset management is only part of the total cost of DC scheme membership; other costs include administration, for example.

fund managers too frequently exercise poor control of costs, which are not necessarily visible to investors and which managers can deduct directly from the value of funds, rather than treat as a business cost that they meet out of their own pockets.

These weaknesses matter greatly. Over extended periods, apparently small differences in the cost of investing can make a material difference to the value of individuals' long-term savings: over a working lifetime, a 1% annual charge could slice the value of a pension pot by a quarter.<sup>5</sup> Furthermore, without a clear idea of the comparative costs and charges of different investment vehicles, individuals and their representatives – financial advisers, trustee boards, the new independent governance committees (IGCs) which will be entrusted to monitor workplace personal pension schemes<sup>6</sup> - cannot make informed judgements about value for money. Price competition is thus impaired.

It is striking that the problems of cost opacity and cost control are both widespread and long-standing. In 2002, the Sandler Report on the UK retail investment market found “the reporting of product charges is typically neither clear nor consistent”.<sup>7</sup> This was despite the prevailing disclosure regime introduced in 1995 by the Financial Service Authority's predecessor, the Securities and Investment Board. Few customers heeded, or understood, the Key Features Document, the forerunner of today's Key Investor Information Document, that was supposed to enable consumers to compare investment products.<sup>8</sup> Similarly, a 1997 Office of Fair Trading (OFT) investigation highlighted the opacity of charges in DC pension schemes.<sup>9</sup>

Little progress appears to have been made. In May 2014, following its thematic review of retail funds, the FCA castigated firms for too frequently providing information on fund charges that was unclear, insufficiently comprehensive and misleading.<sup>10</sup> In its 2013 study, the OFT reported problems of cost opacity similar to those that it had uncovered in 1997.<sup>11</sup>

Members of DC workplace pensions are especially badly placed. The key choices about the scheme and its costs are effectively made by employers, but many may well be ill-equipped, or lack the incentive, to make cost-effective choices on behalf of their employees. Surveys commissioned by the Department for Work and Pensions (DWP) suggest that many employers, unless guided, are unaware of the existence of the most basic scheme charges paid by employees in their DC pension schemes.<sup>12</sup> The Government has responded with a proposal from April 2015 to cap charges on default funds of DC auto-enrolment qualifying schemes, funds that in practice are used by the majority of auto-enrolees. The charge cap is

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<sup>5</sup> Illustrative calculations by the Department for Work and Pensions in November 2013 (“Pensions Bill 2013, Information Pack for Peers”) show that an individual who saves throughout their working life into a scheme with a 0.5% annual charge could lose around 13% of their pension pot at retirement as a result of charges. A 1% annual charge could reduce that pot by 24%.

<sup>6</sup> FCA (August 2014), “Proposed rules for independent governance committees”, CP 14/16.

<sup>7</sup> Sandler Report (July 2002), “Medium and Long-Term Retail Savings in the UK: A Review”.

<sup>8</sup> FSA (September 2007) “Good and poor practices in Key Features Documents” found that only 15% of a sample of KFDs met consumers' needs.

<sup>9</sup> OFT (July 1997) “Report of the Director General's Inquiry into Pensions”.

<sup>10</sup> FCA (May 2014), “Clarity of fund charges”, TR14/7.

<sup>11</sup> OFT (September 2013, revised February 2014), “Defined contribution workplace pension market study”, OFT 1505.

<sup>12</sup> DWP (February 2014), “Landscape and Charges Survey 2013: Charges and quality in defined contribution pension schemes”, Research Report No 859.

set at 0.75% of funds under management, covering many costs but initially with the (very significant) exception of transaction costs arising from the buying and selling of securities.<sup>13</sup>

Persistent problems also arise with the incentives of fund managers to control costs. In 2012, the FSA found that few firms exercised the same vigilance in their expenditure on research and execution services – costs deducted directly from the value of funds under management and therefore hidden from view to investors – as they exercised over payments made from the firms’ own resources. The FSA said: “many firms had failed to establish an adequate framework for identifying and managing conflicts of interest [...] most [...] could not demonstrate that customers avoid inappropriate costs ...”.<sup>14</sup> This conclusion replicated the findings of the FSA’s 2003 investigation, sparked by the Myners Report,<sup>15</sup> into commission arrangements between fund managers and brokers: the opacity of these arrangements meant that managers could “pass on some management costs to customer funds with minimal scrutiny. This creates a significant conflict of interest ...”.<sup>16</sup> Evidently, the reforms introduced by the FSA in 2006 had not effectively solved the problem of misaligned interests between the principal (customer) and agent (fund manager).<sup>17</sup>

The widespread and persistent nature of the problems of cost opacity and cost control suggest underlying structural deficiencies in the fund management industry. These were forcefully identified in the 2012 Kay Review of UK equity markets, which described ‘the decline of trust and the misalignment of incentives throughout the equity investment chain’.<sup>18</sup> Kay notes that “Regulatory policy has given little attention to issues of market structure and the nature and effectiveness of competition, instead developing detailed and often prescriptive rules governing market conduct, with substantial cost and limited success. Regulation should focus on the establishment of market structures which provide appropriate incentives, rather than the fruitless attempt to control behaviour in the face of inappropriate commercial incentives.” He called for the application of “fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions” and for “full disclosure of all costs, including actual or estimated transaction costs, and performance fees charged to the fund”.

## **The Consumer Panel’s Research and Findings**

To examine these long-standing problems and the implications for consumers, regulators, policy makers, and the industry, the Panel commissioned two studies from industry experts: Mr Rajiv Jaitly, a global risk consultant and a member of the expert panel that advised the 2013 OFT study into DC workplace pensions, and a team led by Mr David Pitt-Watson, an executive fellow in the finance department at London Business School and a former director

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<sup>13</sup> However, the DWP indicates in its October 2014 paper, “Better workplace pensions: Putting savers’ interests first”, that it is on a determined journey towards full transparency. It will decide whether to include transaction costs in the cap in 2017, but in the meantime it will require DC trustee boards and IGCs to request information on these costs from their providers. These disclosure details – and the barriers IGCs and trustee boards encounter in securing them – will be reported in trustee and IGC statements about “value for money”.

<sup>14</sup> FSA (November 2012), “Conflicts of interest between asset managers and their customers: Identifying and mitigating the risks”.

<sup>15</sup> Myners Report (March 2001), “Institutional Investment in the United Kingdom: A Review”.

<sup>16</sup> FSA (April 2003), “Bundled Brokerage and Soft Commission Arrangements”, CP176.

<sup>17</sup> FCA (July 2014), “Discussion on the use of dealing commission regime: Feedback on our thematic supervisory review and policy debate on the market for research”, DP14/3.

<sup>18</sup> “The Kay Review of UK Equity Markets and Long-Term Decision Making”, Final Report, July 2012.

at Hermes, the fund manager.<sup>19</sup> The reports provide a “state of play” analysis of the extensive literature on the subject, together with an insider’s view of the way the asset management industry operates in practice. These studies were designed to help the Panel better understand how the industry works in practice, the nature of fund charges and costs, the shortcomings of the current regulatory system, including disclosure, and possible solutions.

The Panel recognises that the issues are complex not just for consumers and their advisers, but also for the industry, government and regulators. However, assigning disclosure, governance and conflicts of interest to the “too difficult” box is no longer an option if consumers are to be treated fairly.

The key findings from the reports and possible options for reform are summarised in the following pages.

## 1. Key Findings

1.1 After a review of a wide range of studies and methods of calculation, the Pitt-Watson team concluded that the full costs borne by savers are simply not known, and costs are deducted from the fund directly by the provider. The main reasons are simply that many costs are not properly measured or declared. Even fund managers frequently do not appear to know: in its survey of fees, consultancy Lane Clark & Peacock, found that around two-thirds of investment managers could not provide information on transaction costs.<sup>20</sup> Moreover, explicit costs charged to the customer – included within the annual management charge (AMC), the total expense ratio (TER) and the ongoing charge figure (OCF) – are a poor guide to the full costs. This was the conclusion of an early (2000) study commissioned by the FSA<sup>21</sup> and holds true in more recent studies surveyed by the Pitt-Watson team. In one study, “total” charges, excluding transaction charges, were calculated (with difficulty) from published, but not necessarily comprehensive, mutual fund<sup>22</sup> price lists. They were typically more than twice the annual management charge in a number of countries, including the UK.<sup>23</sup>

1.2 Even institutional investors of multi-billion pound pension funds may not know the full costs of investing. It took a major study by Hymans Robertson, a pensions consultancy, to find potential for significant savings in the Local Government Pension Scheme by switching to passive investments away from generally underperforming actively managed funds.<sup>24</sup> Similarly, it is reported that Railpen Investments, a £20 billion pension scheme, took many months and encountered great difficulty to

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<sup>19</sup> Jaitly, R. (September 2014), “Collective Investment Schemes – Costs and Charges. Implications for consumers”; Pitt-Watson, D., C. Sier, S. Moorjani and H. Mann (September 2014), “Investment costs: An unknown quantity. A literature review and state of play analysis”.

<sup>20</sup> Lane Clark & Peacock (May 2013), “LCP Investment Management Fees Survey 2013”.

<sup>21</sup> James, K. (February 2000), “The Price of Retail Investing in the UK”, FSA Occasional Paper Series 6.

<sup>22</sup> Mutual funds” (US terminology) are comparable to Europe’s Undertakings for Collective Investment in Transferable Securities (UCITS) or collective investment schemes (CIS).

<sup>23</sup> Khorana, A., H. Servaes and P. Tufano (March 2009), “Mutual Funds Fees Around the World”, *Review of Financial Studies*, Vol. 22, Issue 3, 1279-1310.

<sup>24</sup> Department for Communities and Local Government (May 2014), “Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies. Consultation”.

estimate that the headline fees it paid to asset managers were around a fifth of total costs.<sup>25</sup>

- 1.3 The lack of competition in terms of price and costs stands in stark contrast to the intensity of competition between fund managers in terms of short-term performance, and the attendant emphasis on sales marketing and product proliferation. The Kay Report refers to this phenomenon as “misdirected competition”. The metric used to judge performance is itself unreliable. Five-year performance figures, frequently used in sales and marketing, can be highly misleading, due to the common practice of fund closures, mergers and name changes, which can disguise poor long-term performance after costs: “survivorship bias”.
- 1.4 Frequent monitoring of short-term performance combined with inadequate scrutiny of costs encourages the practice of “closet indexation”, also known as “closet tracking”: funds that charge for active portfolio management, typically of company stocks, but which in practice do little more than mimic the composition of a relevant index. Recent academic studies confirm earlier findings that closet indexation is commonplace, especially in mutual funds outside the United States. According to one estimate, around 30% of such assets are managed by closet trackers in the UK and elsewhere in Europe.<sup>26</sup>
- 1.5 Retail investors are particularly badly placed. They lack the market clout of institutional investors, and may also be exposed to risks of which they are unaware, not least as a result of the practice of combining institutional and retail funds for investment purposes. Retail investors are not adequately compensated for the hidden risks of such aggregation.<sup>27</sup> The retail investor is also unlikely to be able to negotiate changes to indemnity exclusions or even exclusions of liability in contractual terms in an investment management agreement, and has little protection under existing unfair contract law, notably in relation to insurance contracts (“unit-linked” funds) and securities transactions.<sup>28</sup>
- 1.6 Perhaps most problematic is the typically poor governance of retail funds. Jaitly notes that the pool of resources available to provide independent governance is limited. Sometimes governance is contracted out to commercial organisations that have an incentive not to criticise the investment manager who appointed them. Governance can also be provided by an associated group company, with similar conflicts of interest. Even trust structures can be conflicted as a result of overlapping interests.<sup>29</sup> Weak governance was found to be a key problem by the OFT in its 2013 study of workplace DC pension schemes, leading to the proposal to install independent governance committees.
- 1.7 Regulation by the FCA and its predecessors has depended not on the standards of loyalty and prudence implied by a fiduciary duty but has instead emphasised the principles of treating customers fairly, the provision of information that is clear, fair and not misleading and the effective management of conflicts of interest (principles

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<sup>25</sup> Professional Pensions (27 August 2014), “Railpen to reduce external managers over fee concerns”.

<sup>26</sup> Cremers, M., M. Ferreira, P. Matos and L. Starks (May 2014), “The Mutual Fund Industry Worldwide: Explicit and Closet Indexing, Fees, and Performance”.

<sup>27</sup> Jaitly, sections 3.8 and 3.9, explain the uncompensated risks created by “cross-class liability”.

<sup>28</sup> Jaitly sections 3.26 and 6.18.

<sup>29</sup> Jaitly section 3.19

for businesses 6, 7 and 8 respectively). In view of the persistence of non-TCF behaviour, confusing and inadequate information and embedded conflicts of interest, it is difficult to disagree with the conclusion of the Kay Report that regulation has been costly but not self-evidently successful. Jaitly notes that the TCF principle can collide with the industry's profit maximising objectives – a not uncommon problem in financial services..<sup>30</sup> Required disclosure of costs and the use of charge caps (as in the case of stakeholder pension schemes) have been piecemeal rather than comprehensive, partly as a result of stiff and effective industry resistance. In Jaitly's view, the result has been a “waterbed effect”: cost suppression in one place has led to cost inflation in another place, with no net impact.<sup>31</sup> Further problems arise because of regulatory overlap in auto-enrolment DC schemes between, in particular, The Pensions Regulator and the FCA – and their separate ombudsman services.<sup>32</sup> The FCA has far greater powers of intervention and fines, which create the opportunity for regulatory arbitrage – i.e. providers can choose the apparently “light-touch” regulatory regime of TPR.<sup>33</sup>

1.8 Overall, the complexities of retail fund structures, combined with weak fund governance and asymmetries of information and power between the retail investor and the investment manager, have resulted in an extremely unbalanced principal-agent relationship. Profit maximisation combined with incomplete disclosure and poor management of conflicts of interest has skewed the basis on which healthy competition depends.

## **2. Possible Options for Reform**

2.1 One option would be to allow current disclosure initiatives to bed in before considering more radical structural reforms. Current initiatives include European proposals for improved key information documents (KIDs) for “packaged retail and insurance-based investment products” (PRIIPs) and the updated Markets in Financial Instruments Directive (MiFID II). The latter proposes full disclosure of costs, including transaction costs; in its consultation paper, the European Securities and Markets Authority (ESMA) argues that these disclosures should apply to all categories of clients and not just to retail investors.<sup>34</sup> These changes should come into play in January 2017. The IMA has responded with proposals of its own, and has introduced a Statement of Recommended Regulatory Practice (SORP), compulsory for UK authorised funds, which requires disclosure of operating costs, dealing commissions and stamp duty but stops well short of the disclosure envisaged by MiFID II. Such regulatory changes may add to the pricing pressures on fund

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<sup>30</sup> Jaitly section 6.1.

<sup>31</sup> Jaitly section 6.15.

<sup>32</sup> Also confusing is the jurisdiction of compensation schemes such as the Financial Services Compensation Scheme (FSCS) and the Fraud Compensation Scheme (FCS).

<sup>33</sup> Jaitly section 2.4.

<sup>34</sup> ESMA (May 2014), “Consultation Paper MiFID II/MiFIR, section 2.14.

managers resulting from, amongst other things, the Retail Distribution Review innovations and the increased availability of passive (“tracker”) funds.<sup>35</sup>

2.2 However, the history of persistent regulatory failures strongly suggests the need for structural change to align the interests of principal and agent. Moreover, self-regulation suffers from problems of enforcement and representation: non-IMA members account for 17% of UK funds under management. Hedge funds, notably underrepresented by the IMA, have materially added to investment costs.<sup>36</sup> One option therefore is that the FCA considers mandating full MiFID II style disclosure of all costs as soon as possible. However, as Jaitly argues, full disclosure should be seen as a complement to structural reform, not as a substitute.<sup>37</sup> Without a fundamental alignment of incentives, the industry is always likely to find ways around even the most prescriptive forms of regulation.

2.3 Disclosure is only effective if those to whom the details are provided can understand and act on the information; overly complex disclosure to consumers would be counterproductive in many cases. In addition, disclosure alone would not immediately change the incentives for fund managers to control those costs that can be charged against the value of funds and are consequently hidden from the investor. One solution might be a single investment management charge; all other intermediation costs, charges and expenses incurred by the investment manager, including transaction costs, would be borne directly by the firm and reflected in the single charge. A ‘softer’ option would be to allow investment managers to quote the costs of buying and selling (entry and exit) separately.<sup>38</sup>

2.4 A single charge would require firms to price their services in such a way that they remain profitable yet competitive. The single charge regime would place investment managers at risk for the decisions they make and strengthen accountability – to the consumer and also to the firms that employ them. The reform could trigger a sea-change in industry practices and remuneration structures. The Panel fully understands that such a radical proposal would require structural changes in the industry and would be likely to be challenged by investment firms. However we believe a single charge merits consideration because - as Jaitly points out - other options are not working.

2.5 Further to strengthen accountability and stewardship, the Panel believes that the proposal in the Kay Report to impose a fiduciary duty on investment managers to act in the best interests of their customers could be revisited. Kay says: ‘All participants in the equity investment chain should observe fiduciary standards in their relationships with their clients and customers. Fiduciary standards require that the client’s interests are put first, that conflict of interest should be avoided, and that the direct and indirect costs should not require, nor even permit, the agent to depart from

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<sup>35</sup> According to the IMA survey (September 2014), passive funds account for 22% of the £5 trillion funds under management in the UK. The survey notes (page 29) “there is limited evidence as yet of a reduction in the average total cost of [fund] ownership when all components (investment, distribution and advice) are included”.

<sup>36</sup> French, K. (August 2008), “Presidential Address: The Cost of Active Investing”, *The Journal of Finance*, Vol. 63, No. 4., 1537-1573.

<sup>37</sup> Jaitly, section 7.1.

<sup>38</sup> While the IMA has said that it is not possible to include ‘future’ trading costs in the charge, other experts have argued that this is possible. This controversial subject clearly requires further independent investigation on the part of the FCA and the DWP.

generally prevailing standards of decent behaviour. Contractual terms should not claim to override these standards'. Jaitly challenges the Law Commission's view that the existing law works reasonably well and argues that lessons can be learnt from US experience.<sup>39</sup>

- 2.6 The regulator and government could also consider additional ways to strengthen existing governance fund structures to ensure these genuinely represent consumer interests and manage conflicts of interest robustly. The principle of IGCs could be extended to retail investment funds. Consideration should also be given to the powers of IGCs: for example, they could be required to make public statements on performance and value for money. Their powers might usefully include the ability to replace investment managers, where necessary, and, in the case of auto-enrolment, to replace other service providers to the scheme e.g administration. Before the final rules are introduced, it would be highly desirable to ensure that IGCs have the powers necessary to represent and protect scheme members. This may require further collaboration by both the DWP and the FCA.
- 2.7 There could be a requirement for contributions of consumers' original investments to be tracked cumulatively through fund closures and mergers, with the full history of associated costs and performance provided to investors on a mandatory basis.
- 2.8 To help consumers and their representatives assess value for money, the regulator could usefully consider a requirement for fund managers to justify that their management of index constituents was active management, rather than closet index tracking. This would probably require trading disclosure for active managers, that is, to disclose what proportion of their trading was on index constituents and whether they were short or long of the relevant security.
- 2.9 Consideration should also be given to the simplification of collective investment scheme (fund) structures and also to the regulatory regimes for DC pensions, notably the anomalous differences in powers of TPR and the FCA. For example while the FCA can impose unlimited fines, TPR's maximum for an individual is £5,000 and for a firm £50,000.<sup>40</sup>

## Conclusions and Next Steps

The evidence reveals a market characterised by a weak demand side that is rapidly growing numerically, and a powerful industry in which misaligned incentives are systemic and which enjoys, largely unchallenged, the potential to exploit consumer behaviour, product structure complexity and the lack of cost transparency. As such, the Panel believes that this is not a market where competition works in the consumers' best interests.

The possible reforms that emerge from our review are primarily of a regulatory and legal nature and would fall within the remit of the FCA or the government. There would be significant implications for policy makers (for example, the DWP in relation to the charge cap and IGCs) and for the industry in terms of product structures, fund pricing, market practices and remuneration structures, among other factors.

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<sup>39</sup> Jaitly, section 7.6.

<sup>40</sup> Jaitly, section 6.2



The scope of the challenge for reform cannot be underestimated: its solution requires an insight into technical structures and market conduct in equal measure, together with a significant shift in current industry practice.

The prize awaiting consumers should reform prove successful would be a marketplace characterised by effective competition in terms of both the quality and price of asset management services. By the same token, the industry could look forward to a newly burnished reputation for effective stewardship of the nation's savings, and to a reformed regulatory regime that was both less costly and intrusive.

The Panel is publishing this research to aid regulators, policy makers and the industry to ensure that future reforms on investment cost transparency at UK and EU level will be effective in practice as well as in principle.

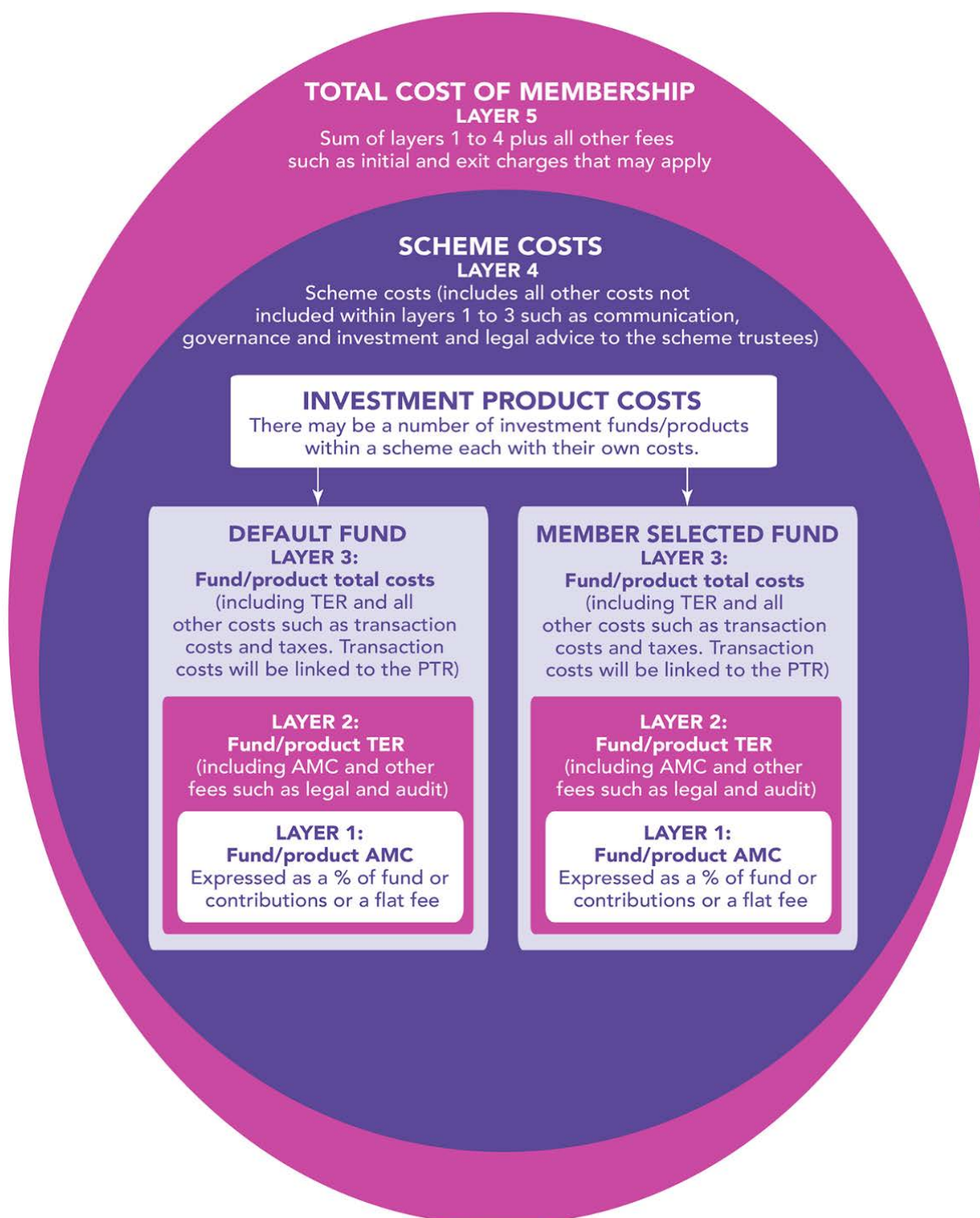


Figure 1 The different layers of costs and charges on a pension scheme as illustrated by the Pension Regulator<sup>41</sup>

<sup>41</sup> <http://www.thepensionsregulator.gov.uk/trustees/costs-and-charges-in-your-dc-scheme.aspx>