A Response to the FCA's Asset Management Market Study Interim Report

The UK Financial Conduct Authority (FCA) published its interim report for the asset management market study (AMMS) on November 18, 2016. Several core themes and challenges in the industry, along with proposed remedies were outlined by the regulator in this report.

The New City Initiative (NCI) engaged with its diverse membership to ascertain what it thought of the AMMS, and its proposals. The general consensus is that while a lot of what the FCA is putting forward is perfectly reasonable and in line with industry best practices, there are some areas which need to be refined.

Price Competition

Regulators globally have been taking a more proactive stance on fees, and the FCA is no exception. Among its assertions in its AMMS was that active managers suffered from weak price competition. The FCA reported that there appeared to be price clustering, with fees at active managers hovering between 0.75% and 1%.

It added that asset managers earned a 36% profit margin on average whereas a firm listed on the FTSE All Share Index made 16%. The regulator was equally forthright on performance, stating most active managers had failed to deliver performance superior to their benchmarks. The regulator also questioned why active management fees had not declined, particularly given the price competition evident in passive fund structures.

NCI members were firm that investors – both retail and institutional – should not be charged fees that fail to reflect performance, which is the ultimate proof of value for money. Institutional investors will scrutinise asset management fees thoroughly, but ultimately if a firm is not delivering returns, that investor will probably not allocate their capital to that manager.

Comparing fee structures at active managers to their passive counterparts is not intuitive. Operating costs at passive funds are naturally cheaper, and NCI members recognise the asset class is increasingly popular. While it is true that passive funds have performed well, NCI members highlighted that their popularity, growth and return streams have coincided with an equity bull market which commenced in 2009. The ability of passive funds to withstand an equity market correction, significant credit event or a period of higher dispersion of stock returns is unknown.

In such downturns, active managers are better disposed to deal with adverse conditions. The FCA's targeting of active managers as being expensive or uncompetitive on fees fails to account for this fact. It also does not acknowledge the sheer diversity of strategies in the active management space, some of which require additional infrastructure to operate.

Furthermore, many boutiques – unlike some of their larger peers – have a solid track record of delivering good performance which is the ultimate yardstick of value for money. Simultaneously, boutiques - of which the NCI represents – are seeing their cost margins go up at a rate which is unsustainable. Fees at boutiques have to reflect the cost pressures of doing business.

"The regulatory burden and operational costs – such as technology – have put pressure on smaller firms. Margins have been getting thinner and thinner over the last few years," said one CEO at an institutional asset manager. While regulation is critical for the industry to function, regulators themselves must recognise this can come at cost, which disproportionately affects smaller fund managers.

Fee Transparency

The FCA's AMMS acknowledged that fee transparency at active managers needed improving. It cited transaction costs, for example, which may not always be properly disclosed to clients or calculated in advance which carries risks in itself, such as inaccuracy. The FCA has said it believes managers should be more transparent about costs throughout the lifecycle of the fund (i.e. sale and on-going disclosure).

The report also acknowledged that alternative funds such as hedge funds and private equity had fee structures that did not always meet its transparency expectations. Alternatives were not explicitly studied but it is an area of the financial services industry, which could face FCA scrutiny down the line.

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Four solutions have been proposed by the FCA as part of its effort to improve fund manager disclosure around costings. The most controversial suggestion is a single charge or “all in one fee” which would incorporate transaction costs. An all-in-one fee is easy to understand, but NCI members acknowledge it poses unintended conflicts.

It is true managers will need to have appropriate governance to determine the charge and act in the best fiduciary interests of the clients. However, there is also a risk that transaction charges are higher than anticipated, meaning manager fees do not cover all costs. This could result in the manager making a loss. Conversely, some managers may overestimate how much transaction costs are, resulting in a sharp increase in fees to the investor. A report by PricewaterhouseCoopers (PwC) concurred, questioning what managers would do exactly with their “profit” if they unintentionally overestimated transaction costs.

“The UK is undergoing an enormous constitutional change by leaving the EU, and the government has stated that it wants the country to remain competitive in capital markets going forward. A single charge or ‘all in one fee’ may be counter to that objective of being competitive. Markets in the EU, US or Canada do not have a single charge approach, so UK fund managers will not be on a level playing field unless disclosure of charges is standardised across the globe,” said one member.

Other asset managers agreed the all-in-one-fee approach posed challenges. “Another unintended consequence of the proposed all-in fee is that it could considerably disadvantage the less liquid strategies - such as quoted Small Caps - which incur higher transaction costs. Because of the importance of the cost of ownership in the decision to buy a fund, an all-in-fee is likely to drive investors away from the less liquid asset classes that offer some of the most attractive returns net of all costs including transaction costs. This could lead to a distortion notably in retail investors' asset allocations and lower portfolio returns in the long run," said one manager.

Others believe it will simply consolidate assets among the biggest managers. “Costs for larger players will undoubtedly be lower as they can leverage their purchasing power across the wider business. This will therefore mean that an all-in-one fee would cause profits to fall the most at the small start-ups or boutique asset managers. This could lead to the unintended consequence of an even more oligopolistic market. Some might see this as a positive or inevitable outcome but from the perspective of a competitive marketplace rather than one that rewards asset gatherers, who arguably are the least differentiated in the passive/active debate, it would seem like an own goal,” said an NCI member.

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If the FCA wishes to increase disclosure and transparency, the NCI recommends this be standardised and suggests that using estimates of future costs could be misleading - it would be better to disclose actual costs from previous years as they are facts that cannot be disputed.

But fee transparency has also been effected through sensible regulation. UCITS, the Alternative Investment Fund Managers Directive (AIFMD) and the Market in Financial Instruments Directive II (MIFID II) all require firms to increase transparency to investors. The industry itself has made substantial improvements on articulating its costs to clients over the last few years.

"Transparency is essential for the continued success of the asset management industry, and this is something we as an organisation and industry group support. At the same time, it is important that costs for managers are controlled, and additional reporting, particularly around areas that are not relevant to the client be minimised. Nonetheless, I feel the industry has made huge advancements in transparency," said one COO.

Switching

The FCA paper criticises the asset management industry for purportedly making it difficult for retail investors to switch share classes. It identified managers often levied charges on investors looking to switch, and said the process could be an administrative headache. This meant investors – predominantly retail - simply stayed in fund share classes which may not necessarily be in their best interests.

NCI members acknowledged that switching share classes was operationally straightforward, and could be done "at a push of a button." However, permission must be given by the investor for switching, and this does create administration, which the clients rarely want anyway.

Perhaps more significant is that switching carries with it tax implications, and can result in investors being subject to capital gains tax. As a result, many investors simply are reluctant to switch. The NCI realises that tax policy is not within the remit of the FCA, but would recommend the government – specifically HMRC - make it more

straightforward from a taxation point of view for investors to switch fund share classes.

Governance

The FCA's AMMS outlined that governance providers at fund managers often did not look into costings and rarely compared asset manager fees to ensure the consumer receives fair value for money. It added that boards often fail to take appropriate and timely steps to address underperformance and sometimes do not possess the authority to challenge the commercial strategy established by more senior boards and executive committees. It also said "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.

A number of recommendations from the FCA were put out to the industry for debate. These include maintaining the existing governance structure, but clarifying the duties of the board; extending the Senior Managers and Certification Regime (SM&CR) to board members; demanding a majority of independent board directors and an independent chair; the creation of a separate independent body modelled on the Independent Governance Committees at DC pension plans but retention of the existing board; the replacement of existing boards with a new governance body with majority independent directors similar to the US mutual fund structure; or place greater duties on trustees and depositaries.

The NCI believes strong governance at fund managers and fund boards is critical to protect consumers. The NCI supports further clarification of the roles and responsibilities of the director, as well as greater independence at the board level. However, the NCI believes cost considerations should be noted. Some of the FCA's recommendations – could result in significantly higher corporate governance costs – at a time when the charges levied by independent directors are getting larger. The creation of additional board structures risks complicating fund managers' set-up, and establishing just another layer of bureaucracy in the investment and oversight process.

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Conclusion

The NCI's position on fees has and always will be that investors should pay for performance. If performance is not present in either active or passive strategies, then market forces will ensure individuals do not invest in them or demand a fee discount from those managers. Equally, the NCI believes there are a number of unintended consequences around an all in one fee charge. The NCI would like to work with the FCA in formulating proposals that will help ensure a competitive and fair asset management industry that can compete globally.

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