Roundtable: Fees and costs in asset management

Fees and costs are controversial issues in the investment industry. **Steven Charlton**, **Aisha Dudhia**, and **Bart Heenk** break down the key challenges in the discourse.

Is there enough transparency in asset management fees and costs?

BART HEENK: Not at all. The average pension fund trustee has limited insight into management fees and no idea of the true costs. This is largely because there is no attempt by the industry to provide clear and complete reporting. In fact most costs are, and remain, hidden unless you specifically ask for them. Even then information is obscured by deliberate and excessive use of jargon. The problem is that often the principals (eg members of the pension fund or retail investors in funds) are not able to ask questions, let alone demand answers or take decisions, and their agents (notably investment consultants) have little incentive to do so. Pension funds should join efforts in forcing industry change or get outside help from an organisation that is less compromised than their investment consultant.

AISHA DUDHIA: Concerns regarding transparency within this sector are nothing new. Regulators, predominantly those in the UK, have been calling for greater transparency in asset management fees and costs for over a decade. Years of partial reforms, amounting only to incremental improvements to existing rules, have forced supervisors to call for wider reforms. Reviews of the current regime have highlighted two persistent problems in terms of transparency for costs. Firstly, services are being bundled together, with eligible and non-eligible services being mixed. Secondly, there is a lack of clarity around how transaction costs, including commissions, have been spent. Considering that transaction costs, alone, can add another 50% to 85% to the overall fees, they are a crucial expense for investors to be aware of. Although the financial services industry has been under mounting pressure to provide greater transparency over fees, the charging structures of some are still far from clear. Under current regulations, fee structures are primarily a percentage of the assets under management and are not necessarily linked to costs incurred. Consequently, when fees are not transparent, nor linked to the costs incurred, clients may find it difficult to assess whether they are getting value for money.

STEVEN CHARLTON: I have two thoughts around this: first, how much transparency is enough? Enough for a trustee or Independent Government Committee (IGC) might be total transparency, so that they can understand just how much they are paying or identify what is causing the performance drag on their investments. Enough for a member might simply be identifying their personal rate of return on the investments

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they've made – ie if I have paid in £X, what do I have Y months or Z years later? My second thought is around DC arrangements. Transparency in DC arrangements should not stop at the door of the asset management industry. The costs associated with asset management are often a small proportion of the overall cost borne by a DC member. Therefore transparency should arguably look deeper, so that trustees/employers and perhaps members know what they are paying and what they are getting for the cost. There may be some services that members are paying for but not using, for example.

How is regulation, like MiFID, changing this?

DUDHIA: Big changes are coming to the fund management industry. In the UK, the Financial Conduct Authority has been looking into various issues, such as how research is paid for; while the Investment Management Association has called for changes to be made to the way information is presented to clients. Plus, big pieces of EU legislation, such as MiFID II, will also have a significant impact on asset managers within the EEA. The MiFID II rules apply to financial intermediaries and call for all costs, ranging from ongoing charges to research fees and detailed transaction costs, relating to investment or ancillary services and financial instruments, to be disclosed to investors. These new regulations encompass a wider range of costs than those previously required under MiFID I, and the costs and charges are required to be presented as an overview, with the possibility of a request for an itemised breakdown. MiFID II requirements do not currently apply to UCITS funds, as greater cost disclosure for these products has only been scheduled for the end of 2019, via the European Union's Packaged Retail and Insurance-based Investment Products (PRIIPs) regulation. Nonetheless, as discretionary and advisory portfolios are captured by MiFID II regulations, UCITS providers will

effectively have to give more detailed information on costs in order to allow intermediaries to comply with the rules.

HEENK: Regulation is almost always several steps behind the industry, is often heavily influenced by politicians and is rarely properly enforced, so I am sceptical about any positive change coming from regulation. The legal system in our country is more than capable of addressing criminal activity in any case. The solution is to have qualified, well informed individuals in the judiciary system, not more regulation.

CHARLTON: MiFID already requires investment firms to provide certain information to clients or potential clients, including on costs and charges. However, MiFID II expands on the existing requirements, in respect of transparency both to retail and professional clients. Examples of additional transparency that we expect to be introduced as a result of MiFID II include aggregated disclosure of information on all relevant costs and associated charges, for example, product costs; advisory charges; administration charges; custody costs; as well as details of any third-party payments, with an itemised breakdown being provided if requested by a client. We also expect the cumulative effect of costs and charges on the return of the investment, and an annual statement of costs and charges in respect of ongoing investment services.

How do you define or measure 'value for money'?

HEENK: At Avida International we have developed a number of specific tools that assess value for money of asset management services. The principles we always use for measuring value for money include whether the buyer's expectations are met, how closely the interests of client and provider are aligned, and competitive benchmarking, ie how well does the provider do in comparison to other potential providers.

CHARLTON: When the terms 'value for money' and 'good value' were written into legislation I did some digging around the US and Australia to see if the concept had been measured outside the UK. The short answer is that it hadn't. So we have to start thinking about our own definition of value. Firstly, we need to look at the scheme and not just asset management. Value is not just about cost: low cost is important, of course, but it's not the only component of value. We also need to acknowledge that there are other services provided and we need to think about the quality of these services. We also need to think about who sees the value. Is it identified in the hands of the member, the employer or the trustee, or mixture of some or all of these parties? How sustainable is it, and what are we measuring it against?

DUDHIA: It is hoped that MiFID II will encourage a focus on quality and 'value for money' within this market. This

should result in more effective competition in the interests of consumers. Still, one technicality that has arisen in light of these new regulations is the difficulty in valuing these goods and services. 'Value for money' aids in assessing whether or not a firm has delivered the maximum benefit from the goods and services it has provided, in relation to the resources available to it. Although, the term measures both the cost and benefit of the services, it also takes into account a mix of quality, resource use, fitness for purpose and time associated. These factors can be used to judge whether or not they constitute good value and together can help in providing a specific price. The bottom line is that, as some elements are subjective, difficult to measure, intangible and misunderstood, market participants will struggle to price their goods and services. Furthermore, the receivers will have to judge whether these goods and services hold the correct value for money, necessitating the creation of pricing mechanisms and billing systems.

Costs are mounting for investment firms. Where are those costs coming from, and is it having an impact on business models? What about pension funds?

CHARLTON: Increased costs are largely a result of legislation. In many cases they are the unintended results of legislation. Take the pensions freedoms as a single example. Any scheme looking to operate a drawdown from within the scheme is going to have to invest heavily in administration infrastructure to be able to cope with the needs and demands (and perhaps expectations) of members. Given the cost and the limited number of members taking up the option initially, it would be unfair to push all the cost back onto initial users. This would create an environment where early adopters would be paying for the service that would be enjoyed by retiring generations to come, which is hardly equitable.

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DUDHIA: When considering the breakdown of the overall cost burden that MiFID II will have on investment firms, the impact of increasing transparency in asset management fees and costs, although significant, is not that onerous in comparison to other aspects. Asset management firms are currently facing large compliance costs, due to the need to focus more on efficiency and transparency under MiFID II. In particular, the majority of firms are looking to set up centralised regulatory functions to ensure compliance with the new rules. IT infrastructures within asset management firms will also require updating. New regulations mean firms will have to establish pricing mechanisms and billing systems, as well as providing a means of publishing information in an easy to understand and consistent format for clients. Additionally, operating costs are expected to rise and, according to PwC, are currently increasing in preparation for MiFID II. In order to deal with cost disclosures and the monitoring of harmonisation of costs, firms have being hiring more employees and investing in new technology.

HEENK: The largest contributor to costs for the average investment firm is compensation. Whilst there is always pressure from star portfolio managers and head hunters to increase compensation, the fact is that compensation costs can easily be controlled. Investment firms would be well advised to follow the examples set in other industries to more effectively link their star performers' compensation with the long-term success of the firm, rather than basing it on short-term performance. Why? Because short-term performance may be a reflection of luck rather than skill, it may reverse and compensation paid out today will be impossible to retrieve in future. Pension funds taking investment decisions in-house are at risk of falling into the same trap, tempted by the argument that in-house costs are almost always lower than paying for external management. Pension funds are well advised to take a long hard look at the relative benefits and disadvantages of insourcing investment decision making.

What more can be done to align fees between investors and managers?

HEENK: Performance fees have always been the obvious answer and remain so, as long as these are very carefully structured and – crucially – independently assessed. Too many times we come across pension funds which think they have struck a good deal but fail to understand the real incentives behind performance fees, like the manager taking more risk when performance is down and vice versa or that it is beneficial for the manager to create a short-term success (and often longer-term failure) to realise the performance fee. Some private equity managers are a bad example of this behaviour, buying companies, leveraging them, cutting investment and costs to the bone, and then selling them before their eventual collapse, creating a short-term gain. The pension fund would have been much better off buying and holding similar publicly-quoted companies or buying the same company with a private equity manager who really adds economical value to the company and its shareholders without any destructive financial engineering. At Avida we feel that fees are better aligned if long term risk and performance characteristics are included.

DUDHIA: The misalignment of fees between investors and managers is commonly referred to as the principal-agent problem, where, although a principal uses an agent to achieve a

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goal, the agent may be motivated to act in his own best interests. Fees and co-investment tend to be viewed as the key elements considered when endeavouring to align the interests of asset managers and investors. Generally, if the elements are combined, using an appropriate mix, then interests are also likely to be aligned. Finding the right mix, however, is difficult. Although asset managers do tend to charge annual management fees, many investors are less willing to invest in a fund where the manager collects performance fees. Advocates of performance fees tend to argue that this motivates managers to generate a higher return. But there are drawbacks, such as a lack of clawback clauses, when using this method alone. Co-investment is the stronger element, when attempting to align interests. Having a significant amount of capital invested along with the principal tends to boost incentives and can improve decision making. Co-investment appears to work best when the manager and the investor have the same goals on time horizon, risk tolerance and the fees paid. When these goals differ, this tends to lower any positive impact that co-investment has on the alignment of interests.

Are fee caps good for the industry or do they lead to unintended consequences?

CHARLTON: Fee caps are a pretty blunt instrument, but I doubt that we have seen the end of them. I suspect that there will be a push to lower costs still further and cap more elements of cost – perhaps transaction costs from the asset management element. Currently we only have a cap on the default accumulation fund, but how long will it be before a default retirement option is required and a cap applied to that? Or even a cap applied to funds outside the default? If this does happen, some of the required innovation around retirement options, such as longevity type insurance/hedging, might not happen. However, if the industry can demonstrate value within the cap, this can only be a good thing for members.

HEENK: Fee caps can work because they force the industry to think creatively about what they might do to provide a commercially attractive service within the cap. However the danger is that this creativity is directed at hiding costs rather than coming up with better solutions. Fee caps are a crude measure. In general it is better to force disclosure and transparency on the industry, though for smaller institutional investors and individuals who have no bargaining power with their investment or fund managers caps are a good solution.

DUDHIA: Implementing fee caps within an industry where there is a clear lack of transparency is likely to result in unintended consequences. In fact, previous attempts to improve disclosure and cap fees have failed due to "stiff and effective industry resistance". Firms wishing to act in the best interest of their investors may wish to introduce caps, as fees tend to erode returns for their clients. Yet, various obstacles across the industry may prevent the successful application of fee caps. In particular, the industry would have to decide at what percentage to cap the total fees to provide a better return for investors and must determine what costs, for example, transaction costs and distribution charges, would be covered by the cap. Overall, under the current regulations, where total investment costs are not ultimately disclosed in full, implementing effective and meaningful caps on fees would be very challenging. Questions surrounding how investment managers would then assess their true value added would arise. Once the new regulations are in place and, if greater transparency is achieved, the industry would be in a better position to assess the impact of fee caps. ■

Biographies

Steven Charlton

Steven Charlton is a defined contribution proposition manager at Vanguard Asset Management. He is responsible for building the firm's DC proposition in markets across Europe, with a particular focus on the UK. He has more than 25 years' experience in the UK pensions industry.

Aisha Dudhia

Aisha Dudhia is a research analyst at the JWG Group. Since joining JWG, she has focused on the implementation issues of MiFID II/MiFIR as well as other trading regulations on participants within the financial services industry. She has a master's degree in economics from the University of Warwick, where she also completed her BSc in Economics.

Bart Heenk

Bart Heenk is managing director and head of Avida International in the UK. He formerly held a number of senior roles at Cardano, SEI, Citibank/Citigroup, and Royal Dutch Shell. He is an economist by training, and lectures at a variety of business schools.