The Financial Inclusion Centre

Financial markets that work for society

FINANCIAL CONDUCT AUTHORITY ASSET MANAGEMENT MARKET STUDY INTERIM REPORT MS15/2.2

SUBMISSION BY THE FINANCIAL INCLUSION CENTRE

We welcome the opportunity to submit our response to such an important initiative. The FCA is to be commended on the analysis of the asset management sector contained in the interim report. Our submission is structured in three sections. Section 1 summarises our proposals for reforming the asset management sector. In Section 2, we provide comments on the main issues raised in sections 4-9 in the interim report. Section 3 contains our feedback to the specific remedies proposed in section 10: Proposed Remedies.

INTRODUCTION

The gathering, allocation and management of assets (asset management) is one of the four primary functions of financial markets[1]. The primary role of asset management is to ensure that capital gets from where it is to where it is needed. But that must be done in the most efficient, economically productive and socially useful way.

For this market to be judged a success, it must serve the needs of three sets of economic actors - the providers of capital (investors), users of capital (real economy firms and government etc), and the wider economy and society - and pass three tests:

- Is the market as efficient as possible so that it produces the optimal net-of-charges risk-adjusted returns for investors (the more value extracted through unnecessary costs, the more investors have to save to offset any losses)?
- Does the market allocate that capital to the most economically productive and socially useful activities to generate the returns for investors and support economic development?
- Does the market create externality costs borne by the rest of society whether in the form of financial crises or environmental damage and so on?

The FCA's market study is limited to consideration of the first test – although it could be said that the more efficient the market is at gathering and managing investors capital, the more of that capital gets through to the real economy rather than extracted in fees and costs into the non-productive sectors.

[1] Along with: banking and payments; financial intermediation and credit creation; and insurance and risk management.

The degree of market failure in this sector is striking and damages the financial wellbeing of investors. Indeed, it is difficult to think of a sector in financial services which is causing quite so much financial harm as measured by the level of value extraction.
The main issue in this market is not lack of choice or lack of competition *per se*. Rather, the 'elephant in the room' which must be addressed is that there are simply too many fund management companies, too many funds, and too many layers of intermediaries in the market – which investors pay for.

As the FCA's own analysis of operating margins shows, even with this proliferation of providers, funds and intermediaries the industry still seems to be very profitable compared to other sectors. This would not be so bad if the existence of all these actors in the market added value by providing investors with better returns on their investments. However, this is not the case as the compelling evidence on the poor performance of high charging active fund managers, and lack of added value provided by financial intermediaries, shows.

Investors are supporting a very inefficient industry and there is a huge amount of value extraction (and it could be argued value *destruction*) in this market. The more value the industry extracts from investors' savings, the more damage is done to their future financial well-being, and the more they have to contribute to offset the damage caused. This is not sustainable especially in an era of projected low growth and low returns.

Therefore, the primary objective of the FCA's interventions must be to force through serious efficiency gains in the market, not *create the conditions* for the market to work. Using a competition lens will not help us address the market failure evident. Lowering barriers to entry, encouraging innovation, providing consumers with more information will make little difference – indeed, this would probably just cause even more spurious innovation and proliferation of products. Investors do not need more choice of providers, products or complex strategies. They need better outcomes.

To make the market work, interventions must be aimed at the structural and supply side causes of market failure such as conflicts of interest in the supply chain, the absence of strong governance, product complexity, and behavioural biases amongst intermediaries and so on.

1. SUMMARY OF FIC RECOMMENDATIONS

We are encouraged by many of the proposed remedies. We would go further in some cases particularly around the issues of who pays for the costs involved in fund management and the responsibilities of intermediaries such as financial advisers, investment consultants and platforms.

We are concerned that the level of market failure is such that interventions are needed urgently to prevent further detriment. We appreciate that the FCA has to consult and weigh up options before acting. But, we would urge the FCA to act as quickly as possible to prevent further harm. The key points of our recommendations are:

- We support the introduction of a fiduciary duty for asset managers and financial intermediaries to act in the interests of investors.
- A version of the RU64 rule is needed for the asset management sector requiring all financial intermediaries (advisers, investment consultants, fiduciary managers, platforms and information providers) to justify why they are recommending active funds/ strategies where an equivalent passive fund/ strategy is available.
- Financial intermediaries (institutional and retail) should be required to provide clients with benchmark portfolios to allow them to compare the end-to-end cost of using complex or

multi-layered investment strategies (such as fiduciary management, DGFs and funds of funds).

- Further restrictions on the use of past performance data in marketing and promotions are needed along with increased duties of care on all forms of intermediaries to warn investors of how misleading past performance data can be.
- Fund managers and various intermediaries should bear all the 'production' costs of fund management and charge clean fees to investors.
- Asset managers and fund governance bodies should ensure that performance bonuses are symmetrical - that is, if the fund manager receives a reward for outperforming a benchmark, there should be an equivalent penalty for underperformance.
- Modules on understanding performance statistics should be included in the training and competence requirements for financial intermediaries (to address the embedded bias towards active fund management despite the evidence to the contrary).
- Major reform is needed to the role and structure of fund governance bodies, with greater independence, enhanced oversight and reporting responsibilities, more explicit duties to promote the interests of investors and manage conflicts of interest (including overseeing the use of reward schemes by fund managers and the use of stock lending).
- In the event of funds underperforming against an approved benchmark, the fund manager should be required to submit a report to the fund governance body explaining why the underperformance has occurred and the remedial action it intends to take. The fund governance body should be required to approve that remedial action plan, and report to investors on success of that remedial plan. Ultimately, the fund governance body should require the fund manager to be replaced or the fund to be closed and merged with another fund.
- Investment consultants and employee benefits consultants should as a matter of urgency be brought within the regulatory perimeter and be subject to full FCA conduct of business rules.
- One of the key market failures is the extent to which financial intermediaries (advisers, investment consultants, platforms and information providers) continue to recommend active funds and retail investors continue to buy active funds. There is a range of reasons for this which we explain in this response. We suspect one of the reasons is the role of the financial media which continues to promote active funds. We would urge the FCA to look at the influence of the media.

We are concerned that the FCA is considering referring the investment consultant sector to the Competition and Markets Authority for formal investigation. This may be a sensible idea, in and of itself, especially if it leads to a break up of this market - although the CMA does tend to default to interventions designed to tackle information asymmetries even though these are not effective in complex markets in financial services.

Rather, the main concern is that any CMA investigation will involve a protracted amount of time before we see any actual measures to fix the very obvious problems. Interventions are needed urgently. The priority should be to bring the investment consultant and employee benefit market within the regulatory perimeter so that the FCA can bring its regulatory interventions to bear. If the FCA does decide to make a referral it would need to work closely with the CMA to ensure that any CMA investigation does not limit the ability of the FCA to act in this market.

2. COMMENTS ON REPORT SECTIONS 4-9

Section 4: How do investors choose between investment managers?

The FCA asks for feedback on confidentiality clauses and MFNs. We are not able to provide any additional evidence on this. But, we would like to emphasise a number of key points.

Firstly, the FCA's own evidence suggests that platforms (which exercise an important influencing role over retail investor's choices) are skewing investor behaviours (and damaging their interests) by not doing enough to make investors aware of the benefits of passive funds.

This must be addressed as a matter of urgency. A version of the RU64 rule is needed in the asset management sector to reduce the risk that intermediaries (advisers, consultants, platforms and information providers) bias the decisions of investors (whether consciously or unconsciously). Given the compelling body of evidence on the lack of added value provided by active funds and the relationship between past and future performance, excluding information about passive funds is clearly detrimental to investor interests.

Secondly, linked to the above point, it is clear from the FCA's own research that past performance is still having an undue effect on the behaviours of institutional and retail investors despite the clear evidence that past performance is no guide to the future.

Further restrictions on the use of past performance data in marketing and promotions are needed along with increased duties of care on all forms of intermediaries to warn investors of how misleading past performance data can be. Of course, investors should be provided with performance data as part of the reporting and accountability process (later we make recommendations on how the role of fund governance bodies can be used to hold fund managers to account) but that is very different to allowing it to be used for marketing and promotional purposes.

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

If platforms were really working for investors, passive funds would be given preferred (or at least equal) billing as active funds and platforms would only include active funds that were willing to reduce their prices through discounts – this would minimise some of the effect of charges on the net-of-cost performance of active funds.

The comparison in fig 5.8 is a very good illustration of why it is important that the FCA addresses the role of platforms. Some platforms look like very good value when considered on the platform costs alone. But, many of these platforms also seem to be recommending the fund solution with the highest charges so when measured by the total cost to investor they are actually amongst the most expensive. This is important as there is no link between high fund costs and superior performance. In most cases, the same outcomes can be achieved using a lower cost solution. Indeed, it may be said that, unlike other markets, there is an inverse relationship between cost and value in asset management. However, the fact that certain platforms are very expensive to use does not seem to have affected the popularity of these platforms. This by definition is a market failure.

The question is: what can be done about this? The temptation would be to reach for information disclosure solutions. The FCA has found that most platforms correctly disclose charges before the point of sale (see para 5.20). But, as mentioned, the fact that certain platforms are obviously more costly than others does not appear to have affected investor decisions very much. Of course, we could make better use of comparative tables to allow investors to compare total platform charges – but this could be difficult to implement. There does seem to be major problems with disclosure after the point at which the investor becomes a customer of the platform.

We have little confidence that improved disclosure on its own will enhance the influence of investors in the platform distribution channel in terms of making platforms more competitive and driving down costs. This is why direct interventions are needed to change the behaviours of the various actors in the asset management supply chain – that is, the fund managers, fund governance bodies, and various intermediaries[2] in this case, the platforms.

The role of platforms in creating effective competition amongst fund managers (the 'product manufacturers'). Is very interesting indeed. The issue is not whether platforms act as a barrier to market for providers. The key point is whether the activities of platforms result in better outcomes for investors. In this regard, even though platforms may not present an obstacle to market, this does not mean they are producing better outcomes for investors. Indeed, if we look at the evidence which shows that platforms downplay passive funds and more than negate low platform charges by promoting high cost funds, it is difficult to see how they could be considered as having a positive effect on competition.

The OCFs levied by funds on platforms included in the analysis in Fig 5.11 are actually quite shocking particularly when the effect of charges on net returns in a low return environment is considered.

It is not quite clear what point the FCA is making in para 5.33. Platform providers may well provide 'due diligence' on the funds they include on their platforms. But to what end? It is not welfare enhancing from the consumer perspective if platforms play an active role in promoting the take up of funds which produce worse outcomes for investors – ceteris paribus, passive funds create better outcomes for investors than active funds and the act of encouraging take up of active funds (whether due diligence is done or not) must by definition increase the probability of getting a relatively worse outcome.

Given that this is a market study, it is somewhat surprising that the FCA did not conduct an in-depth review into the impact of financial advice on competition. The fact that we have already had the RDR is a non-sequitur. The RDR did not address this particular aspect of market efficiency. Remember, effective competition from the consumer perspective is not the existence of numerous providers and products, a plurality of distribution channels in the market, provision of information to consumers and so on (this is the theoretical economics definition of competition). Rather, effective competition from the consumer perspective means a market operating in a way that produces the best outcomes for consumers.

The FCA's very thorough research reminds us of just how much influence financial advice has on investor decisions. £163bn of gross retail sales was done on an advised basis in 2015. If there is evidence that financial advisers are continuing to recommend high cost, underperforming active funds instead of passive funds in large volumes then by definition this is a significant market failure.

[2] The full set includes: information providers and platforms, financial advisers, fund governance bodies, investment consultants, and pension fund trustees.

Of course, it is encouraging that passive funds are taking a greater market share. But it is not enough. The evidence that active funds do not deliver value is compelling to the point of now being incontestable.

The fact that advisers continue to recommend active funds in such high volumes may be explained by two factors – either advisers are exhibiting their own biases (and need financial education) and/or active fund managers are continuing to exert an undue influence over the decisions of financial advisers.

The growth in 'innovations' such as model portfolios is another example of market failure. As the FCA points out investors using model portfolios will pay advisory fees, model portfolio fees, underlying fund fees and potentially a platform fee, with each having an impact on the net return available to the investor.

The issue of third party rating providers is a challenging one. The structure of the relationships in this sub-sector creates obvious risks to investors – particularly with fund managers being required to pay a licence to get rated in the first place. In keeping with our view that it is critical to manage conflicts of interest in the supply chain by requiring fund managers to bear all the 'production' costs in fund management, it would be logical to apply the same principle to financial advisers and other distributors.

Financial advisers and other intermediaries are claiming to add value by producing model portfolios. In those cases where they do this using third party ratings, they should be required to pay for the rating. This would be the best way to address the obvious conflict of interest. The FCA has not yet gathered sufficient evidence on which to act, so we would support any plans for further research in this area. It should approach this using the precautionary principle – that is it should be minded to act to fix these conflicts of interests unless any further research concludes that there isn't sufficient evidence of harm to act.

Whatever the cause of market failure, promoting more effective competition from the consumer perspective needs to address the behaviour of financial advisers. This can be done through a number of interventions which we will describe in more detail later on in this submission. But, in essence it means introducing an RU64 rule for advisers, controlling use of past performance data, managing conflicts of interest through improved governance, and requiring fund managers and various intermediaries to bear all the 'production' costs of fund management and charge clean fees to investors.

The issue of fund governance bodies is clearly one that needs fundamental reform. As the FCA highlights, AFMs are typically subsidiary companies of the company that actually sponsors the fund range, with AFM board members employed within the group in roles that are junior to the group company board members. The FCA has seen only a few examples of independent non-executive direction on those AFM boards.

It is very difficult to see how this structure can be allowed to continue. This goes completely against the principles and practices of good governance. This is not just a theoretical breach of good governance as the FCA has found during its supervision that AFMs do not robustly consider value for money for investors, often fail to challenge underperformance, and that conflicts of interest tend to be resolved in favour of the asset management group.

The use of third party host Authorised Corporate Director, although in principle creating some separation of interests, does not seem in practice to deliver tangible benefits to investors (see para 5.52).

We are concerned about the FCA's approach to Liability Driven Investment (LDI) solutions. The issue is not whether there is a concentration of providers in the market, or that clients can switch but rather whether LDI actually works in producing the return outcomes expected by clients.

To conclude, we agree that the FCA should do further work in the areas discussed above. But, we are concerned that if the FCA continues this work within the remit of the market study, any necessary interventions will take a very long time to materialise. There is sufficient evidence of conflicts of interest and value extraction harming consumer outcomes to warrant the FCA considering as a matter of urgency *regulatory* interventions not *competition* interventions.

Intermediaries such as platforms cannot be said to be acting in the interests of investors if they are not objective in the way they present passive funds to investors. Similarly, intermediaries making use of more expensive model portfolios and funds of funds when simpler strategies involving passive funds would do the same job but more cheaply (therefore, ceteris paribus producing a better net return for investors), cannot be said to be acting in the interests of investors.

The structure and role of third party ratings providers and existing fund governance bodies clearly breach the principles and practice of good governance.

These issues can be addressed through the following measures:

- A clear fiduciary duty for relevant parts of the supply chain
- A version of the RU64 rule for financial intermediaries requiring them to justify to clients why they are recommending more costly active funds and not passive funds which are designed to do the same job
- Requiring promoters of model portfolios to pay for third party fund ratings
- Requiring fund managers to pay for all the production costs in fund management including research and all costs involved in trading and charge clean fee to the investor, and ensuring symmetry in the use of performance bonuses (that is, if the fund manager receives a reward for outperforming a benchmark, there should be an equivalent penalty for underperformance)
- Further controls on the use of past performance data in marketing and promotions, and in subsequent reporting to investors
- The inclusion of modules on understanding performance statistics in the training and competence requirements for financial intermediaries (to address this embedded bias towards active fund management despite the evidence to the contrary)
- Major reform to the role and structure of fund governance bodies, with greater independence and more explicit duties to promote the interests of investors (including overseeing the use of reward schemes by fund managers).

Note that none of these important interventions need to be seen as *competition* measures. These are *regulatory* interventions and could be consulted on as a matter of priority and implemented much more efficiently than competition measures.

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

The issue of the poor net-of-cost performance of active funds has been well documented and there isn't much to say apart from reiterate that while there is plenty of choice and competition in the conventional sense (numerous providers and products), this is not producing a well-functioning market. There would seem to be an inverse relationship between price and value in asset management – generally speaking, the more you pay, the less you get.

Prices on active funds have not moved over the past ten years (see fig 6.14), and financial intermediaries are still far too likely to recommend active funds in the misguided belief that actives will outperform and that there is a relationship between past and future performance despite the evidence to the contrary. The continued existence of so many active funds and the preference of financial intermediaries for these high cost investment vehicles is a de facto market failure.

In contrast, we have seen real innovation and competition in the passive market sub-sector with significant reduction in prices in the past 10 years (see fig 6.17).

What is also striking are the high operating margins generated by the asset management sector (certainly compared to the other economically productive and consumer sectors, see Fig 6.21) despite the oversupply of providers and products and failure to deliver good outcomes to investors.

But, despite the scale of the challenges, this is a market failure that can be addressed through a number of targeted regulatory interventions.

Section 7: Are asset managers willing and able to control costs along the value chain?

Our main comments and recommendations on controlling costs along the value chain are made elsewhere – particularly on an enhanced role for fund governance bodies, tougher regulatory requirements for financial intermediaries and distributors, and the use of benchmarks to highlight the impact of charges on performance.

But, it is worth highlighting some points. The data contained in Tables 7.5 and 7.6 reinforce just how much value is being extracted from investors funds in the form of higher charges paid for active fund management. Investors would benefit to the tune of £10s of billions each year if a greater amount of assets was invested in passive funds and/ or charges on active funds were reduced.

Section 8: The role of investment consultants

The investment consultant sector is a cause for concern particularly given the scale of assets over which they have influence – as the FCA reports, 12 of the largest investment consultants influence decision making on £1.2 trillion of assets.

It is anomalous that the advice and recommendations given by investment consultants on strategic asset allocation is unregulated. Similarly, there are gaps in the regulation of manager selection and rating processes undertaken by consultants, and advice from employee benefit consultants to employers.

The argument for not regulating this sector has been that clients in the institutional investment fund market such as pension fund trustees, local authorities, and charities are sophisticated investors and able to access expert advice from intermediaries such as investment consultants. We think this is misguided. Pension fund trustees are not necessarily more sophisticated than retail investors and are very reliant on expert advice. If that advice is sub optimal then the sums of money involved mean the impact can be significant.

The investment consultant market is relatively concentrated and switching levels are low. But we would emphasise that conventional measures indicating low levels of competition are not necessarily a cause for concern. What matters are the outcomes, and the FCA's research raises a number of serious concerns about the functioning of this sector.

- Investment consultants do not on average add value by being able to identify better performing fund managers
- Investment consultants do not drive significant price competition amongst fund managers – given that they cannot add value on identify better performing fund managers ex ante but could have influence over costs, this is particularly disappointing
- There seems to be little in the way of objective frameworks to allow institutional clients to assess the value of advice on asset allocation and investment strategy provided by investment consultants – again a serious cause for concern given the role investment consultants have played in promoting the popularity of complex and risky strategies such as LDI
- New services such as fiduciary management have introduced new conflicts of interest into the relationship, with a lack of transparency on performance and fees

To examine the sector, the FCA 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?

Of course, these are important questions to consider. But those are 'input' questions that allow the FCA to establish whether it thinks the conditions for competition exist. It is surprising that the FCA did not ask the fundamental question that matters: do investment consultants produce good outcomes for institutional clients for the fees charged? This question is even more relevant given the growth in fiduciary management services.

The FCA may well be right to consider referring this market to the CMA for a fuller investigation. But it is not clear what the CMA would recommend by way of remedies to produce better outcomes for clients. The CMA would probably default to information remedies to get clients to switch even though the FCA research found no propensity to switch (see para 8.14). Unless the CMA is willing to recommend a break-up of the big players to provide opportunities for switching, information remedies are unlikely to produce a well-functioning market given the nature of the problems in this sector (conflicts of interest, complexity, weak client influence and so on).

However, more worryingly, CMA investigations take a long time to complete and while any investigation was under way, the FCA might find itself inhibited in its ability to deploy more effective regulatory interventions to tackle the very obvious root causes of failure in this sector. If the FCA is to refer this sector to the CMA, we would urge the FCA to provide reassurance that this would not inhibit the use of regulatory interventions to tackle the problems identified.

The fiduciary management services sector is another obvious cause for concern. As the FCA points out, 41% of combined advisory/ fiduciary management revenues generated by firms in the sample came from fiduciary management even though this represented just 4% of assets under advice (see para (see para 8.24). Given the effectiveness of 'following the money' as a means of identifying potential detriment, this data should be setting alarm bells ringing. The much higher fees charged for fiduciary management compared to more traditional advisory services compounds these concerns. It is not at all clear what pension scheme trustees get in return for paying such high fees for fiduciary management. Fiduciary management does not significantly reduce the amount of work involved for trustees or change the legal responsibilities of trustees – although there may be a misunderstanding amongst trustees that it does. But if this is the case this is a further case for concern.

Bizarrely, as the FCA reports, we now have advisory firms offering services to help pension schemes choose a fiduciary manager – with these fiduciary managers also advising trustees or acting on a discretionary basis.

Regarding investment consultants, when they go beyond strategic investment advice, it is not at all clear what value they actually offer when we consider the fact that consultant recommended funds do not perform better than non-recommended funds (see para 8.46). Moreover, investment consultants do not appear to be exerting downward pressure on investment fees (see para 8.62).

This is strange given all we know about the futility of investors trying to pick fund managers that outperform on an ex ante basis. Investment consultants, as with financial advisers in the retail market, are making spurious claims if they promote their ability to identify active funds that perform better than passive funds or active funds that can maintain outperformance in the long term.

But, costs are within their influence and both sets of intermediaries can produce value for clients if they do put downward pressure on investment costs.

It is not clear why the FCA says that: '*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*' (see para 8.59).

The need for extensive due diligence and higher search costs has been partly caused by investment consultants exposing pension funds to universes of 000s of fund managers and 10,000s of funds. Exposure to this level of choice does not add value for clients – indeed, the existence of so much spurious choice actually destroys value for clients in the long term. The need for due diligence would be reduced as would search costs if consultants recommended passive funds to implement investment strategies. As mentioned, investment consultants can add value by pushing down costs. They could also add value by putting pressure on the market to simplify and streamline products.

To sum up the role of investment consultants and fiduciary managers, they appear to be contributing to the creation of unnecessary complexity and spurious choice in this market – which in turn then creates opportunities for them to offer yet more services to deal with this additional complexity and choice. But, this is the story of much 'innovation' in financial services - innovations are created to deal with problems and risks created by a previous set of innovations.

There are a number of regulatory interventions targeted at investment consultants, fiduciary managers and other advisers which could address the problems identified here. But it is also clear that measures are needed to improve the skills and confidence of pension trustees and others such as charities who use the services of these intermediaries. They are over reliant on these advisers and as a result are vulnerable to advisers recommending complex, expensive strategies and funds which do not add value.

We would also suggest that the government provides clarity on who regulates the advice provided by investment consultants and other advisers. In our view, The Pensions Regulator (TPR) should remain the 'prudential' regulator for defined benefit schemes and oversight body for all employers' pension schemes in terms of administration and communication with members. But, the FCA should be the conduct of business regulator for investment consultants, fiduciary managers and other advisers in regards to all aspects of investment-related advice to institutional clients. This is why we very much support the recommendation that investment consultants and employee benefit consultants should be brought within the FCA's remit. This should be a priority matter.

The fiduciary manager sector seems particularly opaque. It is quite startling to read that some fiduciary managers do not disclose the fees of underlying managers to clients because of confidentiality agreements with those managers. Nor do they seem to disclose transaction costs to clients.

This sector is growing and it is important that regulatory interventions are deployed as a matter of urgency to limit the potential detriment. These measures should include: a fiduciary duty of care on fiduciary managers; full disclosure requirements; controls on how services are marketed and promoted; and a version of the RU64 rule applied to control the practice of fiduciary managers recommending high cost funds and strategies.

Section 9: Are there barriers to entry, innovation and technological advances?

In this Section, the FCA considers the role of innovation and barriers to entry in the market.

The first point to make here is that the FCA should clarify what it means by innovation. There does not seem to be much evidence that innovation in this market actually benefits end users. Much service and product 'innovation' seems to be designed to deal with risks or problems created by a previous set of 'innovations' or creates more costly ways of achieving the same outcomes rather than add value for clients.

We are now in a rather ludicrous position where new types of advisers have emerged to advise clients on how to choose fiduciary managers whose job it is to advise clients on how to choose a fund of funds/ multi-manager fund manager who in turn chooses underlying fund managers/ funds. There is no evidence that the involvement of all these intermediaries (who cost money) produce better investment outcomes than simple strategic investment advice implemented through passive funds - this by definition destroys value for pension scheme members.

The issue of barriers to entry is not that important. The market is oversupplied with providers and products. Encouraging yet more into the market is not going to benefit end-investors unless those new providers and products drive poor value products and providers out of the market. Rather, if the FCA wants to make this market work better for end-investors, the objective should be to streamline and shrink the market and promote the replacement of complex solutions with simpler, low cost solutions (remember, with regards to investment solutions, generally there is an *inverse* relationship between price and value[3]). This can only be done by regulating more intensively gatekeepers such as investment consultants who have promoted complexity and spurious choice and innovation.

The FCA seems to equate innovation with the introduction of new products and strategies (see para 9.17). As we pointed out in our response to the FCA's Mission document, there is a big difference between innovation from the market perspective (that is lots of activity and new product development) and innovation from the consumer perspective (that is, innovation which produces better outcomes for consumers). The only true measure of innovation is whether it produces better outcomes for consumers – in this case, the better outcomes would be superior net risk adjusted returns. But the FCA does not seem to have actually analysed whether innovations (such as LDI, targeted absolute return funds/ diversified growth funds) are actually producing better outcomes for clients.

There is compelling evidence that it is not worth paying higher fees for active fund management – generally speaking it does not add value compared to passive fund management. It could be argued that the more 'dynamic' diversified growth funds take active management to another level – they use very active asset allocation decisions often coupled with active funds to execute that asset allocation. We don't have enough DGFs with a track record to allow us to draw the same definitive conclusions as we can with active versus passive funds. But, what evidence there is does not look good for DGFs.

Recent research was very critical of the value provided by the DGF sector and prospects for the future[4]. To be fair, DGFs did appear to provide some relative downside protection during the financial crisis. But, since then the performance has been disappointing. Over a period of nearly seven years, the average DGF has only managed to perform in line with a simple 60/40 equity/bond portfolio, before fees are taken into account. However, it is important to consider the impact of fees and once the higher fees associated with DGFs are taken into account, this implies that DGFs underperformed a simpler strategy.

Indeed, the research found that most traditional, liquid DGF managers have actually detracted value through tactical asset allocation. The conclusion was that the fees charged by DGFs are 'generally not commensurate with the alpha achieved' and that many DGFs have 'created the illusion that their insights and active management are valuable, whereas so far most have only delivered market beta (which is almost freely available) through long-term strategic asset allocation'. The report went on to say that the managers of most funds demonstrated low skills in tactical asset allocation, with many actually destroying value through idiosyncratic trading. In the new economic and financial reality, defined by low returns, it remains to be seen whether DGF managers have the skill to add value – particularly if the growth in assets under management continues.

Furthermore, as the FT reported recently, UK domiciled absolute return funds are on course to register record net inflows but two-thirds delivered negative returns in 2016[5], failing to deliver on the basic promise of preserving capital even in difficult market conditions.

So, there are real questions about the added value of DGFs. But, there are other concerns. As explained, DGFs can provide what seems to be a beguilingly simple offer to investors such as pension

[3] Identifying good performance on an ex ante basis is not possible, high charging active managers do not produce better performance than passive managers – the higher the cost of investment the lower the net return produced
[4] Towers Willis Watson, Diversified Growth Fund Investing: is there a better way?
[5] Financial Times, https://www.ft.com/content/077fcff8-6081-11e6-b38c-7b39cbb1138a

fund trustees. However, the strategies underpinning these offers can be very complex and are not guaranteed to deliver. The more complex the strategy, the greater the risk of misselling – even to supposedly more sophisticated investors such as pension fund trustees.

It is important that the asset management sector and the various layers of intermediaries now involved in the supply chain understand the conduct risks involved in selling costly, complex strategies such as DGFs. To manage the conduct risks, it is critical that, when fund managers manufacture and distribute these products, they undertake proper stress testing with the target market to ensure clients understand the reality of offer and complexity of the strategies involved, market these strategies in a fair and transparent way[6], and ensure that those intermediaries advising on these strategies undertake proper due diligence and also market these strategies in a fair and transparent way when promoting these complex strategies to clients.

Overall, we have a serious concern that investors are being sold high cost strategies (particularly strategies involving layers of funds of funds and multi manager products) mistakenly believing that these are lower risk than more conventional, simpler strategies. They are failing to appreciate that these complex strategies are likely to produce worse outcomes in the form of lower net risk-adjusted returns (remember, the worse the return, the higher the contributions required to be invested into a pension scheme to produce the same outcome).

LDI is a particular concern. This involves matching liabilities with low risk matching investments but also using sometimes very aggressive and risky investment strategies (for example, including SWAPs) to generate returns. It is not at all clear that LDI actually makes sense. It is based on 'de-coupling' and separating different parts of a scheme's liabilities. But, there is no evidence that it produces better outcomes than more conventional strategies in the round. However, LDI can be more expensive than conventional strategies and a great deal more complex and more difficult to understand for ordinary trustees.

Furthermore, it may well be that the growth in these more complex strategies (which absorb trustees' time) may well be limiting the capacity of trustees to consider investment strategies which are genuinely economically and socially useful[7] such as ESG investments.

So, to conclude, the concern is not that there are barriers to entry into this market. Rather that the sheer proliferation of providers, strategies, funds, intermediaries (that is, too much 'innovation') is acting as a major barrier to:

- effective competition (from the perspective of clients) and efficient markets;
- trustees fulfilling their duties and meeting their objectives; and
- the market performing one of its primary functions of allocating capital (in this case pools of pension fund assets and new contributions) to economically productive and socially useful activities.

Therefore, if the FCA addressed the market failure evident here using targeted, robust *regulatory* interventions, it would:

- promote effective competition and make markets in this sector more efficient;

[6] The asset management sector undertakes financial stress testing but does not appear to be very good at stress testing investor understanding of complex products. The FCA found that only five of the 19 major investment firms investigated in the review undertook end-user testing to see if they understood the risks involved, Thematic Review, Meeting Investor Expectations, TR16/3, p9 https://www.fca.org.uk/publications/thematic-reviews/tr16-3-meeting-investors%E2%80%99-expectations
[7] See Introduction for the three tests which determine whether a market is working

- help trustees do their job better and deliver better outcomes for pension scheme members (with consequent benefits for employers); and
- enhance one of the primary market functions to the benefit of the wider economy.

Of course, strictly speaking, it could be said that only the first outcome (effective competition) is within the FCA's remit. The second outcome could be said to be within the remit of TPR and the third a matter of public policy not regulatory policy. But, as the FCA highlighted in its important Mission document, FCA interventions in areas within its remit can have an impact on the effectiveness of other regulators and public policy.

The FCA also suggests in this section that the growth in 'outcome-focused' products may be driven by pension freedoms and the desire of advisers to find solutions that match clients' attitudes to risk. This of course is a good thing. Advisers should be trying to deliver outcomes that match investors' needs. But, we don't know whether these new outcomes-focused products are actually delivering for consumers. This is an area which needs further work.

3: COMMENTS ON PROPOSED REMEDIES IN SECTION 10

We have responded to each of the proposed remedies in turn. We very much support the intention of the FCA to introduce 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.

Specific 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

If the asset management sector is to work, major structural reform is needed, not minor revisions or clarifications of duties and responsibilities.

We support the idea that AFMs should have a clear duty to act in the best interests of unitholders. What constitutes best interests needs to be clearly defined, and better reporting needs to be introduced. Delivering value for money must be a priority given the compelling evidence regarding the impact of costs on net returns. Requiring fund governance bodies to consider value for money is unlikely to be sufficient. There should be a duty to ensure value for money for investors.

Critically, these governance boards must be as independent as possible from the firm providing the fund management services. As to the particular options proposed for reforming governance structures, options C and E are the only two that would deliver the necessary independent oversight and behavioural change. We are not clear about the difference in practice between options C and E. However, the key principles of any new fund governance body should be that:

- the majority of board members should be independent (this would also need to be defined as it would be too easy to fill boards with individuals who are not directly connected with the firm but are seen as industry insiders)
- there must be an independent chair
- board members should be subject to the SM&CR

• 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?

Requiring asset managers to have a duty of care to investors should not be seen as an alternative to the above governance reforms. This duty of care should complement and reinforce better governance.

There is much that could be done to ensure that enhanced fund governance bodies and asset managers exercise a new duty of care to act in the best interests of investors. The overarching duty of care should include duties to:

- Ensure value for money for investors
- Ensure the fund manager is meeting the fund's objectives and investors' expectations
- Be transparent to investors
- Manage conflicts of interest
- Take remedial action to ensure that the interests of investors are protected
- Ensure investors are treated fairly

In the table below, we set out how this duty of care could be demonstrated. This is not an exhaustive list.

Table 1: Demonstrating a duty of care to investors

Requirement	How to demonstrate this
Ensure value for money for investors	Ensure investment related costs are minimised; monitor closely and report performance against benchmark; take action to correct failure to perform against benchmark, meet fund objectives (see below); ensure performance fees where used are justified
Ensure the fund manager is meeting the fund's objectives and investors' expectations	The fund governance body should: ensure that the fund manager is complying with the fund's stated objectives; require fund manager to explain underperformance and submit plan to rectify underperformance; report to investors on compliance with objectives
Be transparent to investors	Fund governance body and fund manager should publish all necessary information to allow investors to monitor compliance with objectives, performance against benchmarks; benchmarks should only be changed with the approval of the fund governance body; fund governance body should sign off on fund manager compliance with duty of care and certify whether fund manager has been acting in the best interests of investors; fund governance body should have a duty to demand all information necessary from fund managers to undertake its oversight role, fund manager should be required to supply necessary information
Manage conflicts of interest	Fund governance body and fund management company should be required to identify potential conflicts of interest between investors and the fund manager; this should include oversight of performance fees and allocation of other costs between the fund and fund manager; the use of stock lending practices – for example, to ensure that stock lending does not facilitate activities that harm the value of securities held by the fund

Take remedial action to ensure that the interests of investors are protected	Fund governance body should be required to take remedial action necessary to protect the interests of investors including: requiring the fund manager to take steps to ensure compliance with objectives, improve performance, cut costs and ultimately requiring the fund manager to be replaced or requiring the fund to be closed and merged with another fund
Ensure investors are treated fairly	The fund governance body should have a general duty to ensure that investors are treated fairly; this means all classes of investor within the fund are treated fairly not just ensuring that investors as a group are treated fairly in their dealings with the asset manager - a good example would be ensuring fair treatment between existing investors and new investors, or that investors don't unreasonably pay trail commission

• Are there any logistical challenges and unintended consequences that should be taken into account? If so, how could these unintended consequences be overcome?

There are some challenges to overcome particularly ensuring that there are sufficient independent directors on fund governance bodies. But these are not insurmountable.

The biggest challenge will be the resistance of the asset management sector to change. Interestingly, two of the consequences of proper governance reform could be to i. make asset management firms think twice before launching new funds and ii. if the fund governance bodies do their jobs properly, we could see a major streamlining of the number of funds on the market. A reduction in choice would be a very positive outcome. There is an oversupply of products and providers on the market which is adding to costs and creating complexity.

• Are there advantages to the FCA recommending the government introduce a fiduciary duty by statute which could not be achieved through regulatory reforms?

As we said in our response to the FCA's Mission document, we do think on balance there is merit in introducing an explicit fiduciary duty through statute. We think this would concentrate the minds of asset managers, fund governance bodies and in addition provide a focus for FCA supervisors.

• Are there better alternative supply side remedies that would encourage asset managers to demonstrate that they are providing value for money?

No. There is no real incentive for asset managers in the current market to have to demonstrate value for money.

• 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

It is important that there is a single charge structure. Our preferred solution is that the fund manager bears all the 'production' costs involved in fund management including research costs, administrative and transaction costs and charges a clean fee to the fund. Option D comes the closest to our preferred model. Fund managers should be required to bear any overspend. Of course, on its own this model would create the risk that fund managers would set the single charge higher than it needs to be and retain any unspent costs. It could also encourage more widespread use of closet indexing as fund managers could set a high cost claiming to be active managers but undertake very little trading.

But these risks could be easily dealt with by ensuring that the fund governance bodies is able to exercise proper due diligence over the administration of the fund, has a duty to ensure value for money, and can claw back underspend for the fund.

• 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

A single charge structure is needed (along with other measures) to align the interests of asset manager and investors, and to drive down fund management charges which are extracting so much value from investors' funds. As mentioned, one possible unintended consequence is that this could encourage asset managers to underspend/ closet index. But, as explained, this is easily dealt with and should not be seen as a reason not to have a single charge structure.

• 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?

It should not be limited to retail investors. As explained above, the 'sophistication' of institutional clients is overstated and detriment when it occurs in institutional markets can be significant because of the sums of money involved.

• Whether there are better alternative remedies or pricing models that would encourage asset managers to control the charges taken from funds?

No, we are not aware of any other models that would align interests better and bring down costs. As outlined above, we would prefer a modified Option D.

• 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?

Yes. This should be overseen by the reformed fund governance bodies – including public reporting on whether this has been complied with.

• 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?

Yes. But it is critical that the fund governance body oversees this process and reports to investors on whether these objectives are being met.

• 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?

There are a number of principles that should govern communications and the use of benchmark information:

- there should be an explicit regulatory duty on fund governance bodies and fund managers to ensure that the fund uses a benchmark when reporting to investors (existing and potential) – unless it is agreed by the fund governance body that an appropriate benchmark is not available
- the fund governance body should be responsible for approving and maintaining the most appropriate benchmark for the fund
- past performance should not be used in marketing and promotions
- past performance compared against the benchmark (ideally an equivalent passive fund or benchmark index adjusted for passive fund charges), should be used for reporting purposes
- fund governance bodies should be responsible for overseeing the reporting to investors (potential and existing) on performance against objectives and appropriate benchmarks
- financial intermediaries (eg. advisers and investment consultants) should be subject to an equivalent of the RU64 rule – that is, they should be required to disclose to investors the charges on active funds alongside charges on equivalent passive funds and if they recommend the active fund, justify to investors why they are doing so
- compliance with these requirements should be subject to FCA supervision

• Should we set out our expectations on using benchmarks, particularly when benchmarks are used to trigger performance fees?

Yes. As outlined above, fund governance bodies should exercise greater oversight over the use of benchmarks and performance fees. But, the FCA should set out its expectations and ensure that compliance with relevant duties is part of the supervisory process.

• Should managers be required to take action when funds are persistently underperforming and, if so, what form should this action take?

Yes. With regards to the fund manager, it should be required to submit a report to the fund governance body explaining why the underperformance has occurred and the remedial action it intends to take. The fund governance body should be required to approve that remedial action plan, and report to investors on success of that remedial plan. Ultimately, the fund governance body should require the fund manager to be replaced or the fund to be closed and merged with another fund.

• Is there a role for the regulator in 'shining a light' on poorly performing funds and if so what form could this take?

Yes. The regulator has a clear role in highlighting persistently performing funds. This could be done by the FCA publishing 'thematic' reports on which funds are underperforming along with an assessment of how fund governance bodies are exercising their oversight duties.

• Are there likely to be any unintended consequences and, if so, how could they be overcome?

No. The likely consequences are a streamlining of the market and better outcomes for investors in the form of improved net of cost returns.

• Are there other metrics/indications/pieces of information that could give investors better insight into likely future returns?

It is important that past performance is not used in marketing material to avoid the risk of biasing investor expectations of future performance. It is also important that the FCA controls the way projections are used to illustrate potential performance including mandating the projected returns used for different asset classes. Fund managers and intermediaries (financial advisers, investment consultants, platforms and information providers) should not be allowed to use returns gross of charges when illustrating future performance.

• Do you agree that the focus of any remedies in this area should be on investors in scenarios 2 and 4 outlined above?

No. Clearly, scenario 1 should also be included when remedies are being considered. It is unacceptable that fund managers should be paying trail commission to advisers who are no longer providing a meaningful service to investors.

• 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 share classes and how these costs would arise?

The FCA proposes a number of remedies which we support. The FCA should issue reports 'shining a light' on the differences between old and new share classes to raise awareness of the problem. We also support the proposal to test different communications methods to encourage investors to switch, and the proposal to make it easier to bulk transfer investors to alternative share classes.

But there are a number of additional measures. One intervention would be to require fund managers (or more helpfully, the fund governance body) to contact investors who are paying trail commission and ask them to confirm that they are still receiving a service from and, are happy to continue paying this trail commission to, the adviser who gave them the original advice. Overall, the oversight of the treatment of different classes of investors should be the responsibility of the reformed fund governance body.

We do not have access to the necessary data to estimate the cost of moving investors to cheaper share classes but clearly any costs should be borne by the asset management firm not the investor.

• Are there any potential unintended consequences of remedies in this area?

We cannot think of any damaging consequences from the investor perspective. Of course, the FCA is likely to be challenged by those advisers who are receiving trail commission for providing little in the way of service to investors.

• 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

We accept that displaying charges in a £s format is likely to be better received by investors. But, we are doubtful that it will actually make much difference to investor behaviour unless accompanied by controls on how fund managers, financial intermediaries (advisers, investment consultants, platforms, and information providers), and media use and explain this information.

However, there are a number of important principles that must be followed if cost information (whichever particular format is chosen) is to be effective:

- Fund charges must be presented alongside a benchmark to allow investors to see exactly what they are being asked to pay for – in most cases, this would be an equivalent passive fund. This should apply regardless of which distribution channel used.
- For both point of sale investment and ongoing investment, it is critical that investors are told about all the costs involved regardless of which distribution channel is used. For example, if sold through a platform, this would include a total cost figure with the clean fund cost and the platform charges shown separately.
- While the £ format should be well received by investors, it is important that the compound impact of charges on investment should be shown clearly and explained by fund managers and financial intermediaries (of all types). This could be done by projecting forward and estimating by how much the total costs would reduce the value of the investor's funds. For example,
    - *'Assuming your investments grow at X% a year, investing £XX [lump sum or monthly contribution] in a tracker fund would produce a fund value of £XX,000 after XX years. But, investing in an active fund over the same period would produce a fund value of £YY,000 – a reduction in the expected value of your fund of £ZZ,000'*
    - In the case of regular payments an alternative method might be to show how much the investor would have to increase his/ her monthly contributions by to make up for the effect of costs[8]. So, for example, this might be: '*If you want to build up a fund of £XX,000 over XX years, you would have to invest £XX a month in a tracker fund. But, if you want to build up the same amount using this active fund, you would have to save £YY more each month, an increase of ZZ% each month.*'

- To enhance the effectiveness of disclosure, two additional measures are needed:
    - Clear and prominent warnings are needed about past performance being no guide to the future and the evidence that active fund management is unlikely to provide better returns than passive fund management.
    - A version of the RU64 rule is needed to ensure that financial intermediaries justify why they are recommending a higher cost fund than a benchmark fund.

• What would be the most effective format and mechanism to increase investor awareness of the impact of charges?

See above. The important principles are that investors need to be made fully aware that:

- costs have a real impact on their financial welfare; and

[8] The rule of thumb is that for every 0.5% of ongoing costs an investor has to save an extra 11% each month to make up the difference

- future investment performance is unpredictable and outside their control (including the control of their advisers) but costs are within their control.

The presentation method we outline above should help communicate that impact. But the important issue that disclosure will not have optimal impact unless we have new measures to ensure that financial intermediaries explain the impact of costs and justify why they are recommending higher cost funds.

• 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?

No. We do not envisage any damaging unintended consequences. Indeed, if the combination of better disclosure and RU64 type measures were introduced we believe we would see a much more efficient asset management market – that is, a reduction in costs, a streamlining of the market, and better long term outcomes for investors.

• Are there better alternative options that would encourage investors to become more price sensitive?

See above. The important thing is that the FCA should do more to alert investors to the impact of costs on outcomes, and introduce new RU64 style rules for financial intermediaries requiring them to explain the impact of costs and justify recommending more costly funds. Moreover, we are concerned about the impact of financial media on investor behaviours. But this does not seem to have been considered in the FCA's report. We would urge the FCA to consider this more fully.

• What funds should be in scope of any remedies which encourage greater focus on charges?

We agree that all investment funds should be included in the scope. As the FCA says institutional investors investing in these funds should also benefit.

• What would be the most effective ways to communicate with investors?

We have nothing further to add to the proposals outlined above for improving the way the impact of costs are presented to investors except to say that these methods could be adapted for different communication channels.

• Whether institutional investors would benefit from standardised disclosure of asset management fees and charges?

Yes. As mentioned elsewhere, the degree to which institutional investors are 'sophisticated' is overstated. It is important that institutional investors such as pension fund trustees should understand the impact of charges on investment funds.

But, we do not agree with the FCA's suggestion that the regulator should set the minimum with regards to disclosure and allow the industry to build on this. As with retail investors, the FCA should mandate the information which is to be disclosed, the format in which this information is presented, and the stages at which this information is presented to potential and existing institutional clients.

Moreover, investment consultants and other intermediaries in the institutional market such as fiduciary managers should be subject to an RU64 equivalent.

• What fees and charges information should be included in a standardised disclosure framework?

All fees and charges should be included in a standardised framework determined by the FCA.

• What would be the cost to asset managers of providing information?

N/A

• Would there be unintended consequences if trustees were required to publish costs and charges?

We do not understand the problem described in para 10.50.

• The scope of fund/products that this disclosure template should cover? Should it cover private equity strategies and hedge funds as well?

It should cover all funds/ products and strategies including private equity and hedge funds.

• 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?

A number of problems have been identified in the institutional investment market:

- Investment consultants do not on average add value by being able to identify better performing fund managers
- Investment consultants do not drive significant price competition amongst fund managers – given that they cannot add value on identify better performing fund managers ex ante but could have influence over costs, this is particularly disappointing
- There seems to be little in the way of objective frameworks to allow institutional clients to assess the value of advice on asset allocation and investment strategy provided by investment consultants – again a serious cause for concern given the role investment consultants have played in promoting the popularity of complex and risky strategies such as LDI
- New services such as fiduciary management have introduced new conflicts of interest into the relationship, with a lack of transparency on performance and fees

Above, we have proposed a number of principles for disclosing and presenting information to retail investors. The same principles could be applied to trustees.

- Performance and total costs should be presented alongside a benchmark to allow investors to see exactly what they are being asked to pay for – in most cases, this would be an equivalent passive fund or a model portfolio asset allocation implemented by passive funds. This should apply regardless of which distribution channel used.
- For both point of sale investment and ongoing investment, it is critical that institutional clients are told about all the costs involved regardless of which distribution channel is used and must include a clear illustration of the impact of financial intermediary costs – whether investment consultant or fiduciary manager.

- As with retail investors, it is important that the compound impact of charges on investment performance should be shown clearly and explained by fund managers and financial intermediaries (of all types). This could be done by projecting forward and estimating by how much the total fund costs and total advice costs would reduce the value of the investor's funds. The disclosure examples above could be adapted for institutional clients. For example,
    - *'Assuming your scheme makes a monthly contribution of £XX a month into this product/ fund/ strategy this would produce a fund value of £XX,000 after XX years – based on rates of growth mandated by the FCA and after all costs. But, investing the same contributions in an approved relevant benchmark fund/ strategy for your pension scheme would produce a fund value of £YY,000 – an increase in the expected value of your fund of £ZZ,000'.*
    - Similarly, the investment consultant could be required to show how much the pension scheme would have to increase contributions to make up for the effect of costs[9]. So, for example, this might be: '*To fund liabilities of £XXX,000 over XX years, the scheme would need to invest £XXXX a year in an approved benchmark fund/ strategy. But, to fund the same liabilities using our recommended strategy, the scheme would need to contribute £YYYY more each year, an increase of ZZ% each year.*'

- To enhance the effectiveness of disclosure, two additional measures are needed:
    - Clear and prominent warnings are needed about past performance being no guide to the future and the evidence that active fund management is unlikely to provide better returns than passive fund management.
    - A version of the RU64 rule is needed to ensure that financial intermediaries (investment consultants and fiduciary managers) justify why they are recommending a higher cost strategy rather than an approved benchmark strategy.

• What format should simplified and comparable disclosure take and who should be responsible for providing the information?

We have outlined a simplified format for allowing institutional clients to compare performance and costs above. The FCA should mandate the format for standardising and disclosing information to institutional investment clients. In terms of providing the information, it would seem sensible to share the responsibility between the fund manager providing the fund management services and the financial intermediary (investment consultant or fiduciary manager) providing the advice on the investment strategy.

Comments on our provisional decision to make an MIR

In principle, the idea of a market investigation reference (MIR) on the investment consultancy market to the CMA may seem like a good one. But, we have serious reservations about the potential for such a reference to limit the ability of the FCA to act in this market. Our preference would be for HM Treasury to bring the provision of advice by investment consultants and employee benefit consultants within the FCA's regulatory perimeter as quickly as possible to allow for regulatory interventions to be deployed. The root causes of market failure in this market are best dealt with by regulatory interventions not by competition remedies. If a referral is made, the FCA may be unable

[9] The rule of thumb is that for every 0.5% of ongoing costs an investor has to save an extra 11% each month to make up the difference

to act in this market until the CMA has finished its investigations and proposed remedies. Market investigations by their nature take a very long time to complete.

• 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

Yes. Bringing both these markets within the regulatory perimeter and making them subject to existing and improved conduct of business rules should be a priority.

• 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?

It is not clear what else could be done without these sectors being brought in within the regulatory perimeter.

Further FCA work on distribution in the retail market

Yes, we support the idea of further work on distribution in the retail market. It is not possible to consider how well served investors are by the asset management sector unless the behaviours and efficiencies of distributors are considered.

This marks the end of our submission.

For further information, please contact: mick.mcateer@inclusioncentre.org.uk

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