A Bird's Eye View
Sparrows Newsletter

December 2016

The FCA Asset Management Market Study

Delving into a regulatory market study is perhaps a slightly dry subject relative to our usual monthly output, but the FCA's interim Asset Management Market Study is a remarkable document and a goldmine of information, so please indulge us on this occasion.

The 206 page document can be found at https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf. It was published in November, and the FCA invites comments by 20th February 2017.

The primary focus of the study is to assess whether the market works well, and whether the investment products used by investors offer value for money. The paper draws a number of clear and far reaching conclusions, several of which we look at in this newsletter.

There has been much comment in the press, and several public responses by asset managers who, unsurprisingly, are unimpressed by the FCA's findings. Most of these comments focus on fee levels and selected track record alone, but we find that this defensive approach misses many of the key findings in the document.

The regulator's findings represent a welcome vindication of Sparrows Capital's beliefs and philosophy, and signal a welcome change in the way market performance is assessed and reported.

From our perspective, the key conclusions and statements from the document are the following:

Active versus passive:

The regulator's research underlines the academic findings and Sparrows Capital's belief that alpha is highly elusive:

> "… actively managed investments do not outperform their benchmark after costs." (*Reference 1.25*)
>
> "Institutional active investment products, on average, outperformed their benchmarks before charges were deducted. After charges there was no significant return over the benchmark to institutional products." (*Reference 6.0*)
>
> "Active funds for sale in the UK, on average, outperformed their benchmarks before charges were deducted, but underperformed benchmarks after charges on an annualised basis by around 60bps." (*Reference 6.0*)
>
> "Many active funds offer similar exposure to passive funds, but some charge significantly more." (*Reference 1.27*)
>
> "Some investors appear to be paying 'active' prices for products that are only partly active in nature. Since these products are similar to passive products…. Many investors in expensive 'partly active' products would likely achieve greater value for money by switching to a cheaper passive fund in the same investment category." (*Reference 6.0*)
>
> "Some investors may choose to invest in funds with higher charges in the expectation of higher future returns. However, academic research from the US and recent Morningstar research suggests that higher charging funds are not on average generating higher performance, compared to cheaper funds in the same investment category. Our initial analysis indicates that, while there is no clear link between price and performance, on average the cheapest funds generated higher returns (both gross and net) than the most expensive funds." (*Reference 6.0*)

Of course, these conclusions have been present in the academic literature for years, but it is refreshing to see them tested and verified by the FCA.

Historical outperformance does not herald future outperformance

Many investors continue to believe that they can identify fund managers that will outperform going forward, but the empirical evidence is clear.

> "Past performance does not help investors identify funds that are likely to outperform in the future, mainly because the majority of firms do not persistently outperform." (*Reference 4.36*)

> "There is little evidence of persistence in outperformance in the academic literature, but there is some evidence of persistent underperformance. Our analysis provides some evidence of persistence of relatively poor performance." (*Reference 6.0*)

Comparison tools and advisers do not guarantee enhanced returns

It is interesting to note that even expert advice does not significantly and consistently produce incremental returns.

> "Tools available to assist both retail and institutional investors in identifying outperforming assets, such as best buy lists and investment consultant recommendations, do not allow investors on average to identify products that, after charges, outperformed the benchmark." (*Reference 4.0*)

> "Share classes awarded a 5-star rating by Morningstar do not significantly outperform their benchmarks net of charges; net-of-fees excess returns are statistically indistinguishable from zero." (*Reference 4.48*)

> "Investment consultants rate assets and we found that their ratings do influence which asset managers institutional managers choose. While investment consultants' due diligence means that institutional asset managers are likely to meet minimum quality and operational standards, we have found that these ratings do not appear to help institutional investors identify better performing managers or funds." (*Reference 1.50*)

<u>Investment objectives and performance are often less than transparent</u>

The asset management industry continues to hide costs and underperformance behind a veil of complexity and intransparency. The regulator continues to press for standardisation of reporting, and this can only be positive for investors.

> "We have concerns about how asset managers communicate the objectives and outcomes to investors. Investors may continue to invest in expensive actively managed funds which mirror the performance of the market because fund managers do not adequately explain the fund's investment strategy and charges." (*Reference 10.0*)

> "Some investors seek a target absolute return, rather than primarily seeking outperformance against a benchmark. However, in many cases the funds offering these styles provide misleading performance reporting to investors." (*Reference 6.0*)

> "We reviewed the quality of information reported to trustees by investment consultants and found inconsistencies in in the quality of reporting to trustees boards." (*Reference 4.97*)

<u>Passive solutions are often not presented to investors</u>

Passive and factor investing are rarely part of a firm's default offering when looking to maximise fees. The FCA's Retail Distribution Review (RDR) has improved access to, and recommendation of, low cost solutions, but there is still considerable room for improvement.

> "Investors are not always presented with a choice of passive funds through platforms and rating providers." (*Reference 4.0*)

> "Our findings suggest that the way the passive funds have been presented to investors might have resulted in some investors overlooking passive funds when making investment decisions." (*Reference 4.14*)

> "However, bets buy lists, third party ratings and potentially fund advisers do not give prominence to passive funds…" (*Reference 4.15*)

The importance of costs:

Sparrows Capital has stressed in recent newsletters the profound impact that compounded fees can have on investment performance. The FCA is focussed on educating investors to understand the importance of controlling investment costs and understanding the detail of the purported service offering associated with various fee levels.

> “Even small differences in charges can have a significant impact over time.” (*Reference 1.4*)
>
> “It is important that both retail and institutional investors take information about charges into account when choosing and monitoring investment products as charges are a drag on performance and reduce the net returns investors receive.” (*Reference 4.0*)
>
> “Investors in partly active funds are not aware that they could replicate a similar investment portfolio and risk level with lower charges by using some of their assets to purchase a cheap passive fund with a low tracking error, and use their remaining assets to purchase a fund with more active properties.” (*Reference 6.38*)

It is not often that one receives a seasonal gift from the regulator, but in this case we have received just that. The study reiterates and underlines many of the empirical learnings on which Sparrows Capital’s belief set and philosophy are based.

Currently only 23% of AUM in the UK is managed on a passive basis, and only 3.3% on an enhanced index / partly active / other basis (which incorporates factor investing). A favourable wind is blowing, however, and we detect an increased focus on evidence based investing from the press, from investors, and now also from the regulator.

The genie is out of the bottle!

We would like to take this opportunity to wish you season’s greetings and a happy and prosperous new year.

Mark Northway

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