A Bird's Eye View
Sparrows Newsletter
September 2017

Insights from the FCA Asset Management Market Study - Final Report

In late June 2017, the FCA published its final report on the state of the asset management industry, disappointing many spectators by softening many of the messages contained within the November 2016 interim report. In this brief commentary on the document, we focus on widely reported market criticism that the final report is too soft on asset managers.

The report is at pains to underline that its conclusions should not be interpreted as a recommendation for passive investment over active. It is, of course, not the regulator's role to suggest how investors should invest their capital, and the FCA has worded its findings carefully. Indeed, for the avoidance of doubt, it underlines that:

"*Passive funds, after costs, would generally underperform against the relevant market benchmark*" [1].

The crux of this truism is that index funds have friction costs (management fees, trading costs etc.) that inevitably weigh on its performance relative to a theoretical, non-investable, zero cost index. But of course the cost of owning an index fund is significantly lower than that of an active fund. While active funds often come with management fees of 1.00% or more, index funds often charge less than a tenth of that. The Vanguard S&P 500 UCITS ETF charges 0.07%, exactly the same as the iShares FTSE 100 UCITS ETF[2]. The point is that the fee drag, which should be in all cases subtracted from the expected performance against the index, is substantially smaller when holding index funds.

The FCA goes on to state:

"The market index is a theoretical construct which does not take into account the costs of investing. A cheap passive fund which closely tracks the index will have a low tracking difference and generate net returns close to the market benchmark." [3]

There is a subtle message here: an investor who is buying an index fund does not expect to *outperform* the index. By definition, an index fund is not designed to deliver outperformance. Instead, it tries to deliver an index performance minus execution costs ("the costs of investing") which, in a competitive market, should ideally be as efficient as possible.

Active funds, on the other hand, are *exclusively* marketed as instruments intending to outperform the index. There is no active fund, at least not one we are familiar with, that is sold to investors with the objective of capturing market performance. Indeed, why would any investor buy an active fund, which comes with significant higher costs, if his objective is to merely achieve market returns?

"Active funds for sale in the UK, on average, outperformed benchmarks before charges were deducted, but underperformed benchmarks after charges on an annualised basis by around 60 basis points (bps)."[4]

So the FCA research concludes, like so many studies before it, that active funds, on average and net of fees, deliver 60bpt **less** than the index, every year. It is for the investor – and not the regulator - to decide how to apply this information to their own investment strategy.

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For more information on our philosophy, process or if you just want to challenge these observations, please get in touch.

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[1] Source: https://www.fca.org.uk/publication/market-studies/ms15-2-3.pdf (p. 33, clause 6.3)
[2] Source: ETFs Fact Sheets, as provided by Vanguard and iShares respectively
[3] Source: https://www.fca.org.uk/publication/market-studies/ms15-2-3.pdf (p. 33, clause 6.3)
[4] Source: https://www.fca.org.uk/publication/market-studies/ms15-2-3.pdf (p. 33, clause 6.3)

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