Article taken from Professional Pensions 28 June 2017
https://www.professionalpensions.com/professional-pensions/news/3012784/fca-asset-management-market-study-the-key-points-of-the-final-report-in-full?utm_medium=email&utm_campaign=PP.Daily_RL.EU.A.U&utm_source=PP.DCM.Editors_Updates

The findings of the Financial Conduct Authority (FCA) asset management market study have now been published. Here are the key points in full…

The final report confirmed the findings set out in the interim report published last year - noting:

- That despite a large number of firms operating in the market, there was evidence of "sustained, high profits over a number of years".
- Investors are not always clear what the objectives of funds are, and fund performance is not always reported against an appropriate benchmark.
- The FCA found concerns about the way the investment consultant market operates.

The remedies the FCA are taking forward fall in to three areas.

To help provide protection for investors who are not well placed to find better value for money, the FCA proposes to:

- Strengthen the duty on fund managers to act in the best interests of investors and use the Senior Managers Regime to bring individual focus and accountability to this;
- Require fund managers to appoint a minimum of two independent directors to their boards;
- Introduce technical changes to improve fairness around the management of share classes and the way in which fund managers profit from investors buying and selling their funds.

To drive competitive pressure on asset managers, the FCA will:

- Support the disclosure of a single, all-in-fee to investors;
- Support the consistent and standardised disclosure of costs and charges to institutional investors;
- Recommend that the DWP remove barriers to pension scheme consolidation and pooling;
- Chair a working group to focus on how to make fund objectives more useful and consult on how benchmarks are used and performance reported.

To help improve the effectiveness of intermediaries, the FCA will:

- Launch a market study into investment platforms;
- Seek views on rejecting the undertakings in lieu of a market investigation reference regarding the institutional advice market to the Competition and Markets Authority;
- Recommend that HM Treasury considers bringing investment consultants into the FCA's regulatory perimeter

Final findings

The final findings of the report are as follows:

Price competition

1. The FCA said it found weak price competition in a number of areas of the asset management industry. It said firms do not typically compete on price, particularly for retail active asset management services.
   The regulator said it also carried out work on the pricing of segregated mandates, which are typically sold to larger institutional investors. This showed that prices tend to fall as the size of the mandate increases but said these lower prices do not seem to be available for equivalently sized retail funds.
2. The FCA also confirmed its interim finding that there is considerable price clustering on the asset management charge for retail funds, and active charges have remained broadly stable over the last 10 years.
   It agreed with respondents who said that, in and of themselves, price clustering and broadly stable prices do not necessarily mean that prices are above their competitive level. However, it also found high levels of profitability, with average profit margins of 36% for the firms it sampled. Firms' own evidence to the FCA also suggested they do not typically lower prices to win new business. The FCA said these factors combined indicate that price competition is not working as effectively as it could be.

Performance

1. The FCA looked at fund performance, and the relationship between price and performance. Its analysis found substantial variation in performance, both across asset classes and within them. However, its evidence suggests that, on average, both actively managed and passively managed funds did not outperform their own benchmarks after fees. It said this finding applies for both retail and institutional investors.
2. It looked at whether some investors, when choosing between active funds may choose to invest in funds with higher charges in the expectation of achieving higher future returns. However, its additional analysis suggests that there is no clear relationship between charges and the gross performance of retail active funds in the UK. The FCA said there is some evidence of a negative relationship between net returns and charges - suggesting that when choosing between active funds investors paying higher prices for funds, on average, achieve worse performance. The FCA said similar academic studies of the US mutual fund industry have typically found a negative relationship between fund charges and fund performance.
3. The FCA said it is widely accepted that past performance is not a good guide to future performance - finding it is difficult for investors to identify outperforming funds. The FCA said this is in part because it is often difficult for investors to interpret and compare past performance information. It said that even if investors are able to identify funds that have performed well, this past performance is not likely to be a good indicator of future performance. There is little evidence of persistence in outperformance in academic literature, and where performance persistence has been identified, it is persistently poor performance.
4. The FCA found some evidence of persistent poor performance of funds. However, it also noted that worse performing funds were more likely to be closed or merged into better performing funds. In its additional work, it found that the performance of the merging poorer performing funds improves after they have been merged. However, it also found that the performance of the recipient fund, on average, deteriorates slightly after the merger, although it is not clear that this is a direct result of the merger. While mergers and closures may improve outcomes for some investors, the FCA said not all persistently poorer performing

funds are merged or closed, noting it can also take a long time for worse performing funds to be closed or merged.

Clarity of objectives and charges

1. The FCA said it has concerns about how asset managers communicate their objectives to clients, in particular how useful they are for retail investors. It finds that many active funds offer similar exposure to passive funds, but some charge significantly more for this. The FCA estimates that there are around £109bn in ‘active' funds that closely mirror the market which are significantly more expensive than passive funds.
2. The FCA said it considers value for money for asset management products typically to be some form of risk-adjusted net return. This, it said, can be broken down into performance achieved, the risk taken on to achieve it and the price paid for the investment management services. But it said investors' awareness and focus on charges is mixed and often poor - noting there are a significant number of retail investors who are not aware they are paying charges for their asset management services. However it added that it had found that many institutional investors and some retail investors are increasingly focused on charges.

Investment consulting and other intermediaries

1. The FCA said it found significant differences in both the behaviour and outcomes of different institutional investors. A number of, typically, large institutional investors are able to negotiate very effectively and get good value for money. However, the FCA also said there were a long tail of smaller institutional investors, typically pension funds, who find it harder to negotiate with asset managers. These clients generally rely more on investment consultants when making decisions.
2. The FCA has identified concerns in the investment consulting market. These include the relatively high and stable market shares for the three largest providers, a weak demand side, relatively low switching levels and conflicts of interest.
3. More generally, the FCA recognise that asset managers play a role alongside others in the chain that delivers investment products to consumers. Its analysis suggests that retail investors do not appear to benefit from economies of scale when pooling their money together through direct-to-consumer platforms. The FCA also has concerns about the value retail intermediaries provide.

Package of remedies

Remedies which provide protections for investors who are not well placed to find better value for money:

1. Strengthen the duty on fund managers to act in the best interests of investors through clarifying expectations around value for money, increasing accountability through the SM&CR and introducing a minimum level of independence in governance structures.
2. Consult on requiring fund managers to return any risk-free box profits to the fund and disclose box management practices to investors.
3. Make it easier for fund managers to switch investors to cheaper share classes. The FCA is seeking views on whether it should consider introducing a phased-in sunset clause for trail commissions.

Remedies which will drive competitive pressure on asset managers:

1. Support the disclosure of a single all-in fee to investors. This will include the asset management charge and an estimate of transaction charges. The FCA are testing ways to improve the effectiveness of forthcoming disclosure and will consult on any proposals later in the year.
2. Support consistent and standardised disclosure of costs and charges to institutional investors. The FCA recommend that both industry and investor representatives agree a standardised template of costs and charges and we propose to ask an independent person to convene a group of relevant stakeholders to develop this further. Following this, the FCA said it will work with these stakeholders to consider whether any other actions are necessary to ensure that institutional investors get the information they need to make effective decisions.
3. The FCA will chair a working group to consider how to make objectives clearer and more useful for investors, before considering any subsequent rule changes. The FCA intend to consult on requiring managers to be clear about why or why not a benchmark has been used and requiring that their use or otherwise of benchmarks is consistent across marketing materials. The FCA also propose to consult to clarify that where managers present past performance they must do so against the most ambitious target held out to investors.
4. The FCA is recommending that the Department for Work and Pensions (DWP) continues to review and, where possible, remove barriers to pension scheme consolidation. It said this should help those schemes who wish to benefit from economies of scale that might be achieved by such consolidation.

Proposals to improve the effectiveness of intermediaries

1. The FCA consulted on making a market investigation reference to the Competition and Markets Authority (CMA) to further investigate the investment consultancy services. It said the three largest investment consultants provided undertakings in lieu of the reference. The FCA is proposing to reject the undertakings in lieu and are seeking views from other interested parties on this proposal - and said it is expecting to make a final decision on whether to make a market investigation reference to the CMA in September 2017.
2. The regulator is recommending that the Treasury considers bringing investment consultants into the regulatory perimeter, subject to the outcome of the provisional market investigation reference to the CMA.
3. The FCA has announced it will be launching a market study into investment platforms to look at how competition is working in that market.