Pensions Institute calls for asset managers to reveal full costs of fund management

Investor returns hurt by hidden costs that are at least as big as the visible costs in actively managed funds, says report

Asset managers should be required to reveal the full costs of active fund management to help investors see the full drag on their returns.

The Pensions Institute at Cass Business School has published a white paper calling for asset managers to disclose all visible and hidden costs which are ultimately borne by investors.

Research cited in the paper suggests that concealed costs - such as bid-ask spreads and transaction costs in underlying funds - can make up to 85 per cent of a fund's total transaction costs. The remainder is taken up by visible costs such as commissions, taxes and fees.

Director of the Pension's Institute, Professor David Blake, said: "No good reasons have been put forward for why all the costs of investment management should not be fully disclosed. They are after all genuine costs borne by the investors.

"There is little point in requiring transparency where the reported measure for 'costs' does not include all of the costs, or in the short-term, as many costs as could currently be reported on an efficient basis.

"If total investment costs are not ultimately disclosed in full, how can there ever be an effective and meaningful cap on charges, and how can active investment managers ever asses their true value added?"

Costs could be reported in the form of a 'rate of cost' – which could be deducted from the gross rate of return to give a net rate of return - and as a monetary amount, which could be compared with the monetary value of the investor's portfolio.

The paper suggests a staggered approach could be taken in the lead up to the full disclosure of all transaction costs.

In the initial stage, investment managers should be required to report all visible cash costs involving commissions, taxes, fees, custodial charges and acquisitions costs, together with the hidden cash costs of bid ask spreads, transaction costs underlying funds and undisclosed revenue.

"All these indirect costs relate to the efficiency of the investment management process and all good investment managers should have an estimate of their size," said Professor Blake.

Once investment management firms have the right IT systems in place, non-cash costs should also be reported comprising of market impact, information leakage, market exposure, market timing costs and delay costs (see below).

Professor Blake added: "The hidden non-cash costs would be more challenging to calculate, since they involve the analysis of information that might not necessarily be automatically captured by the investment manager's own systems. Nevertheless, the issue is whether fund manager systems could be configured to generate similar information on a cost-effective basis."

<u>Visible cash costs</u>

- **Commissions**
- **Taxes**
- **Fees**
- **Custodial charges**
- **Acquisition costs**

Hidden cash costs

- **Bid-ask spread** – of the hidden costs, the simplest to understand is the bid-ask spread that a dealer or market maker charges to buy and sell a security or an investment bank charges for, say, a currency hedge. The total spread costs incurred during the year will be related to the annual portfolio turnover.

- **Transactions costs in underlying funds** – if the investment manager buys funds on behalf of the investor, the transaction costs incurred by these funds are not reported even to investment managers, but are still paid by the investor in terms of a lower return.

- **Undisclosed revenue** - the investment manager might also benefit from undisclosed revenue, such as retained interest on underlying cash balances or retained profits from stock lending.

Hidden non-cash costs

- **Market impact** - refers to the reaction of the market price to a large transaction, such as a block sale of securities. The market price will fall in the process of selling the securities and the average execution price will be below the pre-sale price. If the investment manager attempts to execute a large transaction in smaller batches – e.g., by advertising trades to attract buyers or seeking indicators of interest – this will lead to information leakage and will have broadly the same effect as market impact.

- **Market exposure** - refers to the fact that an investor is exposed to what is happening in the market during the period that the transaction is taking place. Suppose the investment manager is planning to buy securities for a client. The client is exposed to the risk that the market price rises before the transaction is executed.

- **Missed trade opportunity** or **market timing costs** are the costs associated with not executing a transaction at the best possible price. Finally, there are delay costs associated with waiting for transactions to complete (e.g., holding the purchase price in a zero-interest account). Some of these non-cash costs can be hedged against – e.g., those relating to adverse market movements – but the cost of the hedge then becomes an explicit measure of the hidden cost.

Memorandum item:
On 13 May 2014, the Financial Conduct Authority criticised the investment management industry for not reporting charges to investors sufficiently clearly. In particular, it criticised the annual management charge (AMC) as failing 'to provide investors with a clear, combined figure for charges'. Instead, it recommended the use of an ongoing charges figure (OCF) which, in addition to the investment manager's fee, includes recurrent operational costs, such as keeping a register of investors, calculating the value of the fund's units or shares, and asset custody costs. In other words, the OFC measures costs that an investment manager would pay in the absence of any purchases or sales of assets and if asset markets remained static during the year. The next day, on 14 May, the Financial Reporting Council accepted the Investment Management Association's (IMA) proposal to report not only the OFC, but also all the dealing costs and stamp duty paid when an investment manager buys

and sells assets in the fund's portfolio. IMA chief executive Daniel Godfrey said: "Our new measure is simple, easy-to-understand and covers every penny spent by a fund…It will give investors confidence that nothing has been hidden." Unfortunately, even with the new information reported, there will remain costs that are hidden.

The white paper is available here: www.pensions-institute.org/workingpapers/wp1407.pdf

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Notes to Editors:

The Pensions Institute (PI) conducts research and provides expert advice on all aspects of pensions. Established in 1996, PI was the first academic research centre in Europe to focus exclusively on pensions.

The Pensions Institute is unique in bringing together internationally renowned experts from across many different disciplines - including economics, finance, insurance, actuarial science, accounting, corporate governance, law and regulation. This interdisciplinary approach enhances strategic thinking towards the development of new solutions to the complex pensions challenges facing states, corporate and individuals, and fosters research and knowledge sharing.

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