ASSET MANAGEMENT: FSUG POSITION PAPER

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About FSUG

The Financial Services Users Group (FSUG) consists of 20 independent experts who represent the interests of consumers, retail investors or micro-enterprises in the EU policymaking process.

The group's remit is to:

- *advise the European Commission in the preparation of legislation or policy initiatives which affect the users of financial services*
- *provide insight, opinion and advice concerning the practical implementation of such policies*
- *proactively seek to identify key financial services issues which affect users of financial services*
- *liaise with and provide information to financial services user representatives and representative bodies at the European Union and national level.*

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INTRODUCTION AND BACKGROUND

In 2013, FSUG commissioned a major research study into the performance and efficiency of the EU asset management industry. The EU asset management industry is huge. Around EURO 10TRN of household assets is managed professionally – 15% of which are investment funds with the bulk, 85%, in pension funds or life insurance contracts. There are 3,200 asset management companies, employing directly 90,000 people and indirectly 500,000 and managing almost 35,000 products.

The sheer size of the industry means that undertaking independent, comprehensive studies of the industry from the perspective of financial users is critical. It is even more important given that policymakers seem to be intent that EU citizens should make increasing use of financial markets to provide for core financial needs such as saving for retirement.

The wisdom of this transfer of risk and responsibility is very much open to question. However, if policymakers insist on continuing with this policy, it is vital that the asset management industry is efficient and offers EU financial users real value (in terms of charges and investment performance), is transparent, and has the confidence and trust of financial users.

HOW TO JUDGE WHETHER MARKETS ARE WORKING FOR FINANCIAL USERS

Before we go on to summarise the details of the research findings and make recommendations, it is important to understand what a successful, effective market looks like from the perspective of the financial user. Any market should be judged according to following primary outcomes:

- **Access:** financial users should have access to and sufficient choice of appropriate products and services
- **Safety:** the financial system, institutions and products should be safe, secure and resilient
- **Fairness and integrity**: users should be treated fairly by firms/ people who act with integrity
- **Efficiency:** markets and financial institutions should be efficient and perform well, competition should work in the interests of financial users[1], markets should produce truly innovative products and services[2]
- **Consumer behaviour:** markets should promote effective choices, decisions and consumption of products
- **Redress**: users should have access to effective redress and wrongdoers held to account for inappropriate, inefficient behaviours and practices
- **Confidence and trust:** users should have trust and confidence in markets (but this must be deserved)
- **Limited externalities:** costs of market failure should not be displaced to non-participants/ rest of society)

It is important to note that these tests apply not just to retail financial services – the root cause of market failure is often found in wholesale/ institutional markets and transmitted down the supply chain to consumers/ real economy.

Readers should keep those tests in mind when reading the report and this position paper.

[1] It is very important to distinguish between the illusion of competitive activity and effective competition that works in the interest of financial users – these are two very different concepts. There is no shortage of competitive activity in financial markets. Whether this competition produces the right outcomes for financial users is a very much open to question.

[2] Again it is very, very important to distinguish between the illusion of innovation and innovation that improves the welfare of financial users. Industry representatives often claim the investment industry is very innovative. There is certainly a huge amount of new product development. But that does not equal true innovation. Much of the product development is simply variations on a theme – the same basic product concepts with new features added for marketing purposes rather than designed to meet financial users' needs. For an innovation to be socially useful, it must improve consumer/social welfare by i. reducing costs/enhancing value, ii. helping manage risk better, iii. improving access, iv. meeting hitherto unmet need, v. producing more efficient allocation of resources in the real economy)

SUMMARY OF FINDINGS

SCOPE AND RESEARCH QUESTIONS

The research focused on investment funds covering 15 EU member states. To understand how well the EU asset management industry performs from the perspective of financial users, and to help us to judge the investment industry according to many of the tests outlined above, we commissioned the contractors to investigate seven research issues:

- Investment performance;
- Fees charged by portfolio managers;
- Correlation between charges and performance;
- Performance of asset allocation;
- Disclosure of costs and transparency;
- Consumer confidence;
- Market structures.

INVESTMENT PERFORMANCE

To analyse investment performance, the report looked at equity funds, bond funds, and balanced funds.

Equity funds

A retail investor investing with a pan-European focus at the beginning of 2003 (a historical low) and who withdrew their investment 10 years later would have achieved an average nominal annual return of 4.4% assuming maximum subscription and redemption fees. Adjusting for inflation, the annual real return would have been 2.2%, or 1.8% if the investor had switched the funds in their portfolio after 5 years.

A comparison of these returns with the variations of the broad European index STOXX Europe TMI (net return), net of management fees for passive funds, shows an average annual underperformance of 1.2% before deduction of subscription and redemption fees (4.4% against 5.6%).

Table 1: Performance of EU equity funds with a pan-European focus of investment (2003-2012)

	Before deduction of maximum subscription and redemption fees	***After deduction of maximum subscription and redemption fees***
Nominal average annual performance	4.7%	4.4%
Real average annual performance	2.5%	2.2%
Real average annual performance with switching behaviour (assuming switched after 5 years)		1.8%
STOXX TMI Net Return: Average annual performance	6.4%	5.6%[3]
Benchmark adjusted for inflation	4.2%	3.4%

[3] Assuming deduction of average maximum management fees for passive funds

A comparison of the average performance of equity funds with the fee-corrected benchmark shows an underperformance of funds in 9 out of 10 years analysed. In 2008, the value of investment funds collapsed slightly less than the whole market (-44% compared to -45%).

Looking at the individual member states, compared to corresponding benchmarks, 9 categories of equity funds underperformed their benchmark while 6 outperformed[4]. Once an adjustment was made for switching behaviour, only 3 out of 15 outperformed. For this analysis, the contractors assumed the investor in the active fund switched after 5 years.

The table in Annex I summarises the findings.

We also asked the contractors to estimate the welfare gain/ loss resulting from the performance of the asset management industry. Over the ten-year period (2003-2012), the average underperformance of EU equity funds weighted by Total Net Assets was 23.6%. Applied to the total net assets of equity funds at the end of 2003 (assumed to be €1,173 bn), the theoretical loss suffered by investors is €277 bn.

The welfare loss is probably even greater once actual investor behaviour is taken into account. Investors tend to switch funds around every five years or less incurring new sets of charges when they switch. This further increases the level of underperformance against a benchmark fund.

Bond funds

The vast majority of bond funds disclose no country limitation concerning their focus of investment. Therefore, it is not possible to compare their performance with any benchmark. Where benchmarks are available, detailed data on performances of funds and their benchmark are reported in Appendix 1 of the report.

Below, we show the performances of bond funds with a pan-European focus of investment. A retail investor investing into bond investment funds with a pan-European investment focus at the beginning of 2003 and who withdrew its investment 10 years later, would have achieved an average nominal annual return of 3% after the deduction of maximum subscription and redemption fees. The real annual return would be about 1% per annum – 0.5% per annum assuming they switched after five years.

The performance comparison with the corresponding benchmark Barclays Pan-European Aggregate TR shows an average annual underperformance of 0.8% net of all fees.

Table 2: Performance of EU bond funds with a pan-European focus of investment (2003-2012)

	Before deduction of maximum subscription and redemption fees	*After deduction of maximum subscription and redemption fees*
Nominal average annual performance	3.3%	3.0%
Real average annual performance	1.1%	0.9%
Real average annual performance with switching behaviour		0.5%
Barclays Pan-European Aggregate TR Gross: Average annual performance	4.7%	3.8%
Benchmark adjusted for inflation	2.5%	1.6%

[4] Note FSUG uses the FTSE All Share Index for UK comparison, the contractors used FTSE 100 index

Bond funds underperformed 7 years out of 10, with especially significant differences in 2008 (8%) and 2011 (6%). The performance low mark of 2008 is followed by a very strong year in 2009, where the benchmark is beaten by about 9%.

Balanced funds

Looking at the data, we see that balanced funds (which are meant to manage risk through diversification) produced a real return of -0.1% per annum over the ten years – in other words not even keeping up with inflation.

Table 3: Performance of EU balanced funds with a pan-European focus of investment (2003-2012)

	Before deduction of maximum subscription and redemption fees	***After deduction of maximum subscription and redemption fees***
Nominal average annual performance	2.2%	2.1%
Real average annual performance	0.1%	-0.1%
Real average annual performance with switching behaviour		-0.3%

It is not possible to select a single benchmark to assess the performance of balanced investment funds as their asset allocation may considerably vary from one fund to another. However since the main components of the portfolio of such funds are equity and bonds, their performance may be compared to both the STOXX TMI index and Barclays' bond index.

The average bond fund returned just under 23% over the ten years (in nominal terms). The Barclays bond index grew by over 40% in the same period while the STOXX TMI Index grew by over 75%.

Money market funds

Short-term interest rates fell to less than 0.5% since the end of 2008 as a consequence of the new monetary policy implemented by most central banks. The performance of monetary investments was obviously also extremely low over the past few years and even negative in 2010 when charges were deducted, which translated into massive withdrawals of investors from this type of investment.

Table 4: Performance of EU money market funds with a euro area focus of investment (2003-2012)

	Before deduction of maximum subscription and redemption fees	***After deduction of maximum subscription and redemption fees***
Nominal average annual performance	0.9%	0.8%
Real average annual performance	-1.0%	-1.1%
Real average annual performance with switching behaviour		-1.2%
EuroMTS Eonia TR: Average annual performance	2.0%	1.3%
Benchmark adjusted for inflation	0.1%	-0.6%

A retail investor investing into money market investment funds with a focus on the euro area at the beginning of 2003 and who withdrew its investment 10 years later would have received an average nominal annual return of 0.8% if he was charged the maximum fees. However, the real annual return would be clearly negative (-1.1%). Again, the average fund underperformed the relevant benchmark over the period.

FEES CHARGED BY PORTFOLIO MANAGERS

The study found a small reduction in average annual management charges but subscription and redemption charges have actually risen over the period analysed. We also know from other sources that EU investors pay higher investment fees than their counterparts in the USA. According to EFAMA (the European industry body) itself the average expense ratio of US domiciled retail equity funds was 0.95% versus 1.77 % for European domiciled equity funds in 2011.[5] By 2013, the expense ratio for the US equity funds was down to 0.74%[6].

EU passive funds charged considerably lower maximum management fees in recent years, at 0.61% in 2012 compared to 1.05% in 2002. Indeed, maximum management fees for passive funds decreased in all countries but Finland and Sweden.

CORRELATION BETWEEN CHARGES AND PERFORMANCE

Since investment funds represent a major part of "the market", it is not surprising that average performances over a long period may be close to the benchmark. Therefore, it is important to verify the consistency of fund performances necessary for investors willing to select the best performers.

To do this, the contractors analysed the proportion of funds that remained in the top performance quintile over rolling periods. The contractors chose all European Union equity funds regardless of the investment focus, a total of 9 192 funds, and identified the top performers from the period 2003-2007. For these 1,839 top performing funds, the contractors analysed how many of them were still among the top performers for the period from 2008-2012. Only 31% remained among the top performers.

Hence, for savers, it is generally not possible to make investment choices on the basis of past performance. The study confirms other research studies that found no correlation between high charges and better investment performance, and that past performance is no guide to future performance.

This is an important point when considering:

i. the information fund managers and intermediaries should be allowed to use when promoting investment funds to investors; and
ii. the fiduciary duty fund managers and intermediaries should have to investors when promoting funds or advising on fund selection.

PERFORMANCE OF ASSET ALLOCATION

In addition to stock selection, fund managers are supposed to add value through asset allocation – that is deciding on the appropriate mix of assets (equities, bonds, cash, property, alternative investments and so on) to be held in a portfolio.

So, we also asked the contractors to evaluate how good fund managers are at resource and asset allocation. It is difficult to evaluate this issue so it is necessary to use proxies. The contractors compared the performance of flexible funds (which gave fund managers discretion over asset allocation) against balanced funds (which constrained the freedom of fund managers). The contractors found that flexible funds actually underperformed balanced funds suggesting that asset managers do not add value on asset allocation.

[5] https://www.efama.org/Publications/Statistics/Other%20Reports/EFAMA_Fund%20Fees%20in%20Europe%202011.pdf
[6] http://www.ici.org/pdf/per20-02.pdf

Table 5: Performance of EU flexible funds vs. EU balanced funds (2003-2012)		
		After deduction of maximum subscription and redemption fees
Flexible funds	**Nominal performance: 10 years**	19.8%
	Nominal average annual performance	1.8%
Balanced funds	**Nominal performance: 10 years**	29.8%
	Nominal average annual performance	2.6%

DISCLOSURE OF COSTS AND TRANSPARENCY

In addition to the basic skills of the fund manager and cost efficiency of the fund management firm, there are two important issues that may have an impact on the efficiency of the EU asset management industry from the perspective of the investor:

- disclosure of charges; and
- conflicts of interest arising from the methods for remunerating portfolio managers and distributors.

How the investment industry manages disclosure and conflicts of interest also determine whether investors receive appropriate advice on suitable products.

This is an important issue. A recent paper from the UK Financial Services Consumer found that major problems in relation to governance and disclosure[7]. Some of the key conclusions the Panel reached were:

- Incomplete disclosures on costs and charges make it difficult to compare and make good decisions. Actual charges may be easily double headline measures like the Annual Management Charge (AMC), as many of the charges are deducted directly from the fund and remain hidden. Indeed, the research concludes that '*it is not possible from the literature to know with any accuracy, the costs borne by the saver*'.
- Fund structures are complex and not well understood, leading to a lottery of outcomes for Consumers.This complexity is frequently driven by regulatory and tax requirements, rather than by how investment managers actually manage funds in practice. Differences in fund structures can create a lottery of outcomes for retail investors in terms of costs, risks and protection.
- Weak fund governance and poor conflict of interest management does not work in the interests of consumers.
- Fiduciary duties of investment managers to protect consumers are 'usually an illusion'
- Performance reporting can be very misleading
- Asymmetry of information in the principal-agent relationship between investors and managers
- allows investment managers to exploit retail investor behavioural biases, such as investor inertia.

[7] http://www.fs-cp.org.uk/publications/pdf/investment_%20david_pitt_%20watson_et_al_final_paper.pdf, http://www.fs-cp.org.uk/publications/pdf/investment_report_executive_summary_for_the_%20fscp.pdf

Disclosure of charges

Critical information relative to UCITS funds should be disclosed in the Key Investor Information Document (KIID) outlined in the UCITS IV Directive (Directive 2009/65/EC). KIID should be made available to any investor before they subscribe to a fund and provides a summary, in a harmonised form, vital information about: objectives and investment policy; risk and reward profile; charges; past performances; and practical information.

In April 2014, the European Parliament and the European Council backed a European Commission's proposal on a similar mandatory "Key Information Document" that will cover all products sold to retail customers through banking channels, financial advisors or via the internet. Structured products issued by banks, insurance-based products, investment funds and some private pension products will be covered, allowing for a comparison between the products, whatever their "wrap".

This is an important development. A major problem with regulation in the past has been the way regulation has been undertaken in 'silos' – that is, separate regulatory regimes for investment funds, insurance based products, personal pension products, alternative investment funds and so on. This has resulted in fragmentation, inconsistent investor protection and confusion – and more expensive regulatory costs. The regulation has been designed to match specific corporate and legal forms rather than the needs of investors. There is no real justification for this silo approach. Even though these products may have different corporate forms, they are supposed to fulfil the same purpose for investors – accumulating assets for the future.

So, it is welcome that we will have a more coherent, consistent regulatory regime for these products. Of course, it is now critical that any new regime is enforced properly or else the benefits will be lost.

Concerning charges, the KIID should include: the maximum entry and exit charges; ongoing charges in the preceding year as a percentage of the Net Asset Value (NAV); performance fee in the last year as a percentage of the NAV and the method of calculation of such fee; and portfolio transaction costs when they are material.

The method used to calculate transaction costs is not precisely defined in the directive, although some professional bodies have set standards. For example, in the UK, the Investment Management Association (IMA) published guidelines for "enhanced disclosure of fund charges and costs" in September 2012. In May 2014, IMA published a "Statement of recommended Practice" for financial statements of UK authorised funds, which included a summary of the statement of total returns of any fund in the annual report. Each type of expense should be disclosed in the notes of the annual report, with the details of expenses payable to each fund manager, to the depository and any other third parties. The Financial Conduct Authority (FCA) will require funds to publish annual information in accordance with these standards for the accounting period commencing after the end of 2014 at the latest.

Mandatory disclosure of fees and commissions should be provided both in % and in money terms for a given investment amount as we believe that most individual investors have difficulty understanding percentages.

As the investment products tend to be recommended for a certain holding period, consideration needs to be given on how much the investor is expected to pay in charges over this advised holding period to show expected return after charges have been applied.

There is a weak relation between the charges applied and performance actually delivered to the investors. Therefore, further initiatives should focus on how to present information to investors so they can understand the additional risks they are exposed to.

FSUG thinks it is worth experimenting with the idea of implementing “over-performance” and “under-performance” fee structures, where the designer of the product (issuer) should be obliged to present relevant market benchmark for performance evaluation purposes. If a portfolio managers diverges from the benchmark, the fund should be considered as actively managed and performance-based fee structure should be applied that reflects the actual performance of the fund against respective benchmark. However, the fund manager should be allowed to select the respective benchmark (with oversight from regulators) that describes at least the strategic allocation of the portfolio with some indication for tactical allocation.

It is important to ensure that clients actually receive the information outlined in the directive. It is critical that clients should be provided with the KIID before subscribing to an investment fund, not ex- post. In a similar context, evidence has been found that only half of the clients received the “European Consumer Credit Information” (SECCI) foreseen in the directive 2008/48/EC on credit agreements for consumers.[8] This cannot be allowed to happen with investment funds.

Some advertisements or commercial documents may diverge from the KIID. For example, in France, the financial markets authority (AMF) mentioned that it had to intervene to impose consistency between legal and commercial information[9].

Of course, while improvements to disclosure are very welcome, it is important to recognise that information disclosure *per se* is not that effective at tackling information asymmetries between financial institutions/ intermediaries and investors. Most importantly, information disclosure is not effective at dealing with conflicts of interest between financial institutions/ intermediaries and investors. Further interventions are needed. In other words, information is necessary but not sufficient.

Conflicts of interest

The fees paid by portfolio management companies to distributors are a real cause for concern due to the potential for conflicts of interest raised. The distributor may have incentives to sell products that do not suit the interests of final clients.

Article 23 of MIFID II foresees that Member States should “*require investment firms to take all appropriate steps to identify and to prevent or manage conflicts of interest…including those caused by the receipt of inducements from third parties”.* Article 24 establishes limitations to the payment of commissions that the distributor can receive from third parties:

- If the distributor is a portfolio manager (either the manager of a fund or in the framework of a mandate) or claims to be an independent advisor, fees, commissions or any other monetary benefits will be banned or will have to be passed on to the final investor[10].
- Other distributors will be allowed to receive inducements only if those are designed to enhance the quality of services and do not impair the firm’s duty to act “honestly, fairly and professionally” and if such inducements are disclosed to the final investor.

This provision was inspired by the new regulations introduced in the United Kingdom, following the Retail Distribution Review. This has led to a fall by 13% of fees charged to retail investors in 2013.[11] Similarly, in the Netherland, the “Provisierbod”” implies that Dutch banks may no longer receive commissions from asset managers to distribute their funds since January 2014. According to the results of a case study of the Dutch investors association VEB, this has led to a general lowering of

[8] Source: Report from the Commission to the European Parliament and the Council on the implementation of Directive 2008/48/EC on credit agreements for consumers, COM(2014) 259, May 2014

[9] Annual report (2013) of the Autorité des Marchés Financiers, page 48 of the French version, 2013.

[10] However, minor non-monetary benefits will be allowed if they are disclosed to the investor.

[11] Source: McKinsey research cited in the Financial Times; 22 June 2014: “Asset manager profit overtake pre-crisis peak”.

management fees, although some banks have compensated by higher tariffs for keeping the account or higher service fees.

Independent advisors play a major role in the distribution of financial products in the United Kingdom. In a number of other countries, financial advisors play a rather minor role when compared to universal banks. The impact of the new regulation remains to be studied in those countries. Three cases have to be considered:

- Smaller independent financial advisors may be unable to change their business model from remuneration by commissions received from portfolio managers and many of them are, therefore, at risk of disappearing. For example, two thirds of the French financial advisors' work is compensated by commissions rather than by fees[12] and the industry fears that clients will be reluctant to pay explicit commissions for the advice received. They argue that only the richest clients will be able to benefit from their services.

- Bank retail networks in the mass market will have no incentive to promote products managed by portfolio management companies not belonging to the same group. Indeed, an account manager would become an "independent advisor" as soon as they proposed products differing from the standard offer of the bank. Hence, the bank would not receive any remuneration for this sale and the account manager is unlikely to receive any personal incentive for such sale.

- Private banks will still be able to compensate the shortfall of inducements by raising the commission charged to wealthy individuals for managing their assets, although the pressure of competition necessarily limits their ability to do so.

In total, some market participants fear that the "open architecture" model, where a distributor sells products managed by entities outside the group, will be less favoured, at least for the small clients. A return toward vertical silos would mean less competition, and, possibly, higher prices.

A second area of potential conflict of interest concerns the relation between asset managers and brokers. It is common for the cost of research to be included in trading fees charged by brokers, which is then allocated by asset managers to investors either directly or through the NAV of investment funds. Although financial research is mainly a fixed cost, unbundling practices mean that the charge for research may be excessive as it depends on trading volumes.

The practice of "corporate access" by which a bank or a broker charges his client for organising meetings with CEOs or CFOs of listed companies can also lead to abusive practices when asset managers allocate this cost to investors. These practices raise issues of transparency; they distort competition and generate conflicts of interest. Since asset managers do not pay with their own funds for such services they are not incited to control their cost, at the expense of investors.

[12] Source: Morningstar, "The IFA Landscape in Europe", Supplement to Morningstar magazine, June 2014.

CONSUMER CONFIDENCE AND TRUST

The Market Performance Indicator (MPI) of the EU "Consumer Scoreboard" is a composite index derived from surveys run in each EU country. It includes four components:

- The ease of comparing goods or services on offer (comparability);
- Consumer trust in suppliers to comply with consumer protection rules (trust);
- Problems experienced and complaints;
- The extent to which markets live up to what consumers expect (satisfaction).

The MPI of the Market for investment products was 69.9 was the lowest score among all 52 markets at an EU level in 2011 and 2012. In eight countries, the market for investment products, private pensions and securities is ranked consistently in last position among all products and services markets.

Looking at the data for 2013, we see that investment products ranked 32nd out of 32 service industries and 54th out all 54 product and service categories[13]. Details of rankings of investment services against other service industries in each country covered can be found in Annex II.

MARKET STRUCTURE

According to McKinsey,[14] operating profits of the asset management industry in Western Europe jumped by 24% in 2013, at almost €12.1 bn. However, operating profits were still below their 2007 peak. Retail investors pushed profits higher thanks to €130 bn investment flows into mutual funds.

Many small entrepreneurial portfolio management companies were created in the last decade. In theory, this trend should stimulate competition and innovation. Fragmentation of the industry also pushes prices up; industry sources indicate that portfolio management companies can hardly break even with less than €100 m of managed assets. The relative weight of funds domiciled in a European country other than the domestic country of investors increased dramatically over the last 20 years.

Costs of investment funds could be reduced in the future by economies of scales resulting from an industrial concentration and/or a reduction of the number of products. There are 3,200 asset management companies, employing directly 90,000 people and indirectly 500,000 and managing almost 35,000 products. The number is even greater once other types of similar products are factored in.

[13]http://ec.europa.eu/consumers/consumer_evidence/consumer_scoreboards/10_edition/docs/consumer_market_brochure_141027_en.pdf
[14] Quoted by ft.com, "Asset manager profits overtake pre-crisis peak", 22 June 2014

FSUG CONCLUSIONS AND RECOMMENDATIONS

The research findings contained in this report raise serious questions for policymakers and regulators. Considering this research, and other recent reports, we conclude that the asset management industry fails many of the tests we outlined above.

The underpeformance of the asset management industry appears to be producing a huge welfare loss for EU investors. The industry does not appear to be producing good value for investors with higher fees not producing better performance. This new research confirms previous research that, for savers, it is generally not possible to make investment choices on the basis of past performance.

Moreover, the consistently poor performance of the sector in the EU Consumer Market Scoreboard raises serious concerns about the fair treatment of investors and behaviours within the industry. The low levels of confidence and trust financial users have in the industry is not a sign of irrationality on the part of financial users. Rather, the low levels of trust and confidence would appear to be well deserved and is a sign of financial users behaving rationally.

We hope this new research helps policymakers and regulators understand the need to reform this hugely important sector. It is illogical and dangerous to continue to expect financial users to make increased use of this industry to save for the future and for retirement without first improving the efficiency of the industry and consumer confidence and trust.

But the question is: what can we be done to make this hugely important industry work for financial users?

The measures contained within UCITS IV and MiFID II should lead to some improvements in terms of disclosure of charges and conflicts of interest. However, information disclosure, while necessary is not sufficient. More fundamental structural reforms are needed.

Policymakers and regulators need to develop an asset management sector action plan to address the obvious inefficiencies in the industry. Moreover, the measures we propose would also make a significant contribution to the development of a more efficient, accessible single market in asset management.

Several measures are needed to address poor investment performance and inefficient competition including:

- Maintaining the mandatory and standardised (comparable) disclosure in the KIID of past performance of funds <u>and</u> of their chosen benchmarks[15], despite this requirement having been most unfortunately eliminated by the new PRIIPs Regulation.
- Regulating the use of past performance data in marketing and promotions – this data is misleading and results in investors making sub optimal decisions.
- Regulating the use of investment projections in the KIID and in marketing and promotions – asset managers should be required to use realistic projections (based on the asset allocation of the fund) set by the regulator.Regulating disclosure of charges – asset managers and intermediaries should be required to disclose **<u>all</u>** charges borne by the investor using a simple, clear measure. Mandatory disclosure of fees and commissions should be provided both in % and in money terms for a given investment amount.This should apply regardless of the distribution channel.
- Improving the training and competence of intermediaries who play an important part in influencing investor decisions.

[15] As designed in the UCITS IV Directive and following ESMA rules.

- Tightening the regulation of investment advice – advisers and intermediaries should be required to disclose and explain why they recommend actively managed funds instead of passively managed funds when those are available. In effect, this would be similar to the very effective RU64 regulation introduced in the UK which ensured that the introduction of stakeholder pensions improved the value of personal pensions[16].
- More generally EU supervisors must do more to ensure that low cost index ETFs are eventually proposed to individual investors. ESMA itself recognises that those funds are currently almost only distributed to institutions in Europe.
- Regulating the conflicts of interest along the supply chain – this includes the relationship between asset managers and intermediaries/ advisers, and asset managers and analysts and brokers. Better information disclosure should address some conflicts of interest. But this is not sufficient.
- Structural reforms are needed. Retail Distribution Review style reforms should address some of the conflicts of interests. But we also propose that asset managers should bear all the transaction costs in managing a portfolio – not just research costs – and charge the investment fund a transparent fee based on assets under management. If active trading results in better performance, then the investor and asset manager gains. If active trading or churning does not produce outperformance, then the investor would be protected from high transaction costs. This would clearly align the interests of asset managers and investors.
- We also propose that policymakers assess the potential for implementing "over-performance" and "under-performance" fee structures, where the designer of the product (issuer) should be obliged to present relevant market benchmark for performance evaluation purposes. If a portfolio managers diverges from the benchmark, the fund should be considered as actively managed and performance-based fee structure should be applied that reflects the actual performance of the fund against respective benchmark. However, the fund manager should be allowed to select the respective benchmark (with oversight from regulators) that describes at least the strategic allocation of the portfolio with some indication for tactical allocation.
- Fiduciary duties – new measures are needed to ensure that the various fiduciaries in the supply chain (depositaries, trustees, custodians) exercise their duties responsibly and act in the interests of clients. The legal duty to act in the best interests of investors needs to be made more explicit. This should include a requirement to sack the asset manager if consistent underperformance is evident and seek to merge investment funds if this would improve economies of scale.

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[16] The mechanism that actually led to reduction in personal pension charges was the RU64 rule introduced by the Financial Services Authority (FSA). This required financial advisers to justify to the client why they were recommending a personal pension that had a higher charge than a stakeholder pension. This forced insurance companies to significantly cut their charges down to the level of stakeholder pensions. Applying a similar rule to intermediaries who insist on recommending more expensive active management funds could be an effective way of making competition more effective and bring down active management charges.

ANNEX I: SUMMARY OF COUNTRY EQUITY FUND PERFORMANCE

Country	**Outperformance (O)/ Underperformance (U) assuming 10 years**	**Adjusted for switching behaviour**
Belgium	O	U
Denmark	U	U
Finland	O	O
France	O=[17]	U
Germany	U	U
Greece	O	O
Italy	O	U
Netherlands	U	U
Poland	U	U
Portugal	O	O
Romania	U	U
Slovakia	U	U
Spain	U	U
Sweden	U	U
UK[18]	U	U

[17] French funds outperformed by just 0.1% per annum
[18] Note that FSUG prefers to use the FTSE All Share Index for the UK rather than the FTSE100 used by the contractors.

ANNEX II: RANKING OF INVESTMENT SERVICES, PENSIONS AND SECURITIES IN EU CONSUMER MARKET SCOREBOARD, 2013

Country	Ranking out of 32 service sectors	
Austria	31	
Belgium	30	
Bulgaria	28	
Croatia	31	
Cyprus	27	
Czech Republic	30	
Denmark	29	
Estonia	30	
Finland	29	
France	24	
Germany	26	
Greece	22	
Hungary	30	
Iceland	29	
Ireland	30	
Italy	28	
Latvia	25	
Luxembourg	26	
Malta	17	
Netherlands	32	
Norway	30	
Poland	31	
Portugal	27	
Romania	29	
Slovakia	32	
Slovenia	32	
Spain	27	
Sweden	32	
UK	31	
EU 28	out of all 32 services	out of all 54 products and services
	32	54