UKSIF
UK Sustainable Investment and Finance Association

18th December 2015

Mahin Choudry
Competition Division
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Dear Ms Choudry,

We are responding to your request for submissions on the topics raised in MS15/2.1 – the asset management market study.

UKSIF is the membership network for sustainable and responsible financial services in the UK. We promote and support responsible investment and other forms of finance that advance sustainable economic development, enhance quality of life and safeguard the environment. We also seek to ensure that individual and institutional investors can reflect their values in their investments. UKSIF was created in 1991 to bring together the different strands of sustainable and responsible finance nationally and to act as a focus and a voice for the industry. UKSIF has around 240 members and affiliates including financial advisers, institutional and retail fund managers, pension funds, banks, research providers, consultants and NGOs. For more info about UKSIF, please visit www.uksif.org.

Introduction

Our fundamental concern with the review as we interpret your current plans is that it may not address the most important issues at all. The risk is that you seek to optimise competition using an out-dated model of the market when signs of fundamental change are already visible.

Our position is predicated on several views and factors which we expect to combine to shape the arena for asset management. Many of the subsequent changes we expect are to be welcomed and if the FCA can accelerate them it would benefit savers.

- First, the aim of investment on behalf of savers is delivery of long-term net of fee returns. The principal driver of these will be market movements, not fees. The focus of your work should be ensuring that the asset management industry best delivers exposure to the upside in asset markets whilst avoiding downside risks which are becoming apparent.

- Second, there are threats to long-term returns from a wide variety of issues such as climate change, resource depletion and consequent geopolitical risks. These threats to value are material and probably unprecedented outside periods such as world wars and the great depression. They will probably produce a pattern of asset price returns, volatilities and correlations different to those underlying most current investment modelling, thereby fundamentally challenging the validity of that work. The threat to savings from this change will be greater if the regulatory environment does not contribute to a focus on the long-term and on new factors in investment. Failure by the FCA to operate effectively in this regard will directly affect your ability to protect consumers and markets, two of your three objectives.

- Third, we expect the role and rights of savers of all kinds to develop. This will affect the way that asset managers are chosen by individual savers, or by agents acting on their behalf in the case of, for instance, pension savings. It will also affect how and to whom fund managers report, and how they are held to account. As an example we expect that at some point in the relatively near future the Independent Governance Committees (IGCs) of DC schemes will have to appoint member representatives.

- Fourth, and linked to the third point, we expect the current trend of Government-led changes to the personal savings market, evidenced by auto-enrolment and pension freedom, to continue to lead to demand for new products.

We think that within a decade the need will be for asset management which can cope with a different return environment and with savers enjoying greater freedom of action, greater voice and greater rights. In this context undue focus on current operating models is potentially dangerous.

We comment on various aspects of the problem and of the document against this background. We are not in a position to make detailed points in respect of the second and third areas of the paper.

<u>Higher level points</u>

<u>Competition</u>

There can be no doubt that net investment performance is both the product asset managers sell and the prime criterion on which they are selected. It is, of course, why asset management services exist and are bought.

The difference in performance between good and bad funds is marked. Over any extended period the difference will typically amount to several percent a year as the following table of annualised returns from various unit trust sectors over ten years shows[1]:

Sector	Annualised ten year performance of **best** fund	Annualised ten year performance of **worst** fund
UK All Companies	14.6	5.1
UK equity income	11.1	2.1
N. American equity	9.0	<0.1
Sterling corporate bond	6.2	<0.1

[1] Source: UKSIF calculations from data in “Investment Life and Pensions Moneyfacts, December 2015”

It will be noted that the difference in annual return far exceeds the range in annual fee levels shown in figure 6 of the terms of the reference paper.

Performance is what should matter in asset management purchase and in general we assert that it does, especially in institutional asset management. Whilst differences in fees and service will play a part in the ultimate purchase decision, performance will be key in short-listing potential suppliers.

That such wide ranges in performance can exist suggests there are weaknesses somewhere in the asset management market but that they are not necessarily linked to costs and fees. We think they reflect the difficulties clients of many kinds face in managing their affairs on a long-term basis and the linked difficulty in forecasting investment returns.

<u>Innovation and capacity to react</u>

There is no shortage of fund management product and there is a steady stream of new product launches. We would argue that at one level, the short-term, this is evidence of a competitive market which should reassure you about the likelihood of customers generally having a satisfactory experience. Asset managers innovate because it is worth the effort, suggesting a dynamic and evolving market.

Our concern, however, is that the vast majority of products are driven by the existing business model and investment environment and that the current situation does not encourage innovation able to cope with significant change: it appears that the challenge of longer-term innovation is not being met. We question why, given the increasing attention being paid to sustainability issues by a wide variety of market participants- such as investment banks, asset managers and some asset owners, we are not seeing more products designed to mitigate risks such as climate change, resource depletion and poor corporate governance.

Some products and investment approaches *are* being designed to meet these challenges, often by UKSIF members, but there appear to be obstacles to their adoption and growth. We suspect this problem in long-term innovation is linked to two things. First, there is something in the widespread perception that financial markets are driven by short-termism. There is a tendency to focus on the near-term, partly driven by the ubiquity of performance data and the prominence given to performance driven rankings in some areas. The ability to measure something when other more important factors such as future returns cannot be measured risks distorting assessment. We recognise the possibility that biases in asset manager remuneration may also drive a short-term bias.

The second factor is perhaps more serious. We think much of the existing regulation, governance and best practice surrounding around asset management clients limits their ability to buy innovative products and thus the ability of asset managers to innovate profitably. We would cite three examples:

- despite the Law Commission review of fiduciary duty it is not being made clear to defined benefit pension scheme trustees that, in the words of the Law Commission, they "should consider all material financial risks"[2];
- In DC schemes IGCs at Insurance firms seem to be being tasked with trimming basis points off costs rather than focusing on the emerging investment risks linked to sustainability;
- In the retail market we hear from financial adviser members of UKSIF that their peers will not begin to prioritise sustainable investment because of consequent increases in the cost of professional indemnity insurance and the risk of regulatory complexity.

Against the background of growing concern over sustainability issues, highlighted by the recent COP 21 meeting, one might expect rapid change in asset management approaches and product. Change is occurring but these examples of impediments in three distinct market areas show why innovation is slow.

We would urge you as part of the market study to use an issue such as climate change as a test case and to examine the obstacles to innovation with asset managers, investment consultants and asset owners (retail and institutional). We feel the light this will cast on the wider asset management market environment will better inform your study. We suspect such research will confirm the message of the Law Commission work that some revision of the regulatory statements on trustee duties is necessary in the DB space, with the expectation that that revision could then transmit that thinking more widely into investment markets.

By addressing the barriers to innovation on the demand side you would dramatically increase the scope for asset managers to scale up rapidly and profitably the innovations which we know are underway among UKSIF members.

Responses to points in the paper

How do asset managers compete to deliver value?

4.11. We generally agree with the definition of value for money you provide in paragraph 4.11, but we repeat our observation that by far the most significant element of that is the asset return.

In that context paragraphs 4.13 and 4.14 are extremely important. Future returns cannot be known, but as we have said the likelihood that they will differ substantially from those of the past is now extremely high. Because of the use of modelling based on historic returns data- a data set which does not include a period of unprecedented anthropogenic global warming, because of an understandable caution on the part of professional advisers and because of a short-term bias in the system, the "proxies" for returns used are very likely to be seriously inaccurate. In that event the

[2] Law Commission, *Fiduciary Duty of Investment Intermediaries*, 2014 available at: http://www.lawcom.gov.uk/wp-content/uploads/2015/03/lc350_fiduciary_duties.pdf
NB: the emphasis is in the original, it is not added by UKSIF.

assertion in 4.14 that price is "significant" determinant of future return would become even less valid.

We think that if the study looks in detail at asset manager understanding of, and approaches to, medium- and longer-term issues then a better forecast of how the asset management market will evolve will result.

4.23. We agree with your summary of consumer attitudes in 4.23. As a country we need to save more and, for instance, we have to persuade people of the benefits of pension auto-enrolment. It is at present unrealistic to expect retail savers to consider very many issues linked to such saving at all. This highlights why all the agencies involved in the regulatory system more widely- not just the FCA but also TPR and DWP- have to act on their behalf by taking the long view and moving their attention from an undue focus on current fees and operating models.

For all regulators, managing basis points of costs when the challenge is to asset values is dangerous. Let us consider the analogy of boiling a frog. You can either seek to influence the temperature of the water by giving attention to how asset managers address the long-term, or risk becoming the frog by focusing exclusively on this year's operating metrics.

4.31. The feedback from UKSIF members across the UK asset management value chain is that competition is intense at every point.

4.35. We have alluded to the regulatory difficulties some financial advisers have reported to us as reasons why some advisers do not consider wider sustainability issues. We will comment at greater length on this in our response to the FCA's Financial Advice Market Review consultation.

4.46 & 4.45. Asset management is a people business. Other people businesses -professional services, the arts, banking, sport, senior management generally- also show a pattern of high margins and/or high remuneration. Your comment that high margins are seen in asset management globally would seem to confirm that it is the nature of the service provided not the market or business model that drives the margin.

Our view is that asset management margins are already under pressure and that this pressure will increase. There are real risks if your assessment does not recognise this. As sustainability issues begin to bite and as customer voices become (rightly) louder, asset managers will have to consider more factors; apply them to more asset classes; buy more data; meet more companies in new sectors; consider political and regulatory perspectives in new geographies, new subject areas and newer (longer) time frames; report to clients in new ways; recruit more staff to serve clients. This will not be cheap and it is right that it shouldn't be cheap.

Are asset managers willing and able to control costs and quality along the value chain?

We cannot comment in detail in this area. We would, however, suggest that current asset manager margins do not suggest profligacy with costs at that level, whilst no individual fund manager will tolerate his or her individual performance being compromised at the fund level by inappropriate allocation or control of costs in client funds.

How do investment consultants affect competition for institutional asset management?

We cannot comment in detail, but again would make some observations.

We think consultants are part-victim and part-driver of some of the short-term thinking which is a problem for the asset management market. It is not surprising that institutions rely on their consultants. They are expert in investment theory and practicalities. They have wide experience and know the market well. It can be argued that, for instance, defined benefit pension trustees should not seek to do without such expertise.[3]

However, as with other parts of the current asset management market the consultants can be caught by prevailing thinking and become too constrained in their way of operating. This is evidenced in the way that the consulting industry seems to recommend managers that have performed well recently rather than those that are new or undergoing change. This is a much repeated claim but there are enough instances to give it some weight.

Investment consultants are also caught by the difficulty of only having historic data to inform their analysis. As we said above, we think the future will differ radically from the past. We seem to have a culture and a system of professional behaviour, perhaps driven by liability concerns, where the consultants are reluctant to extrapolate too far from the known, historic returns in their modelling. Some way of letting all constituents in the asset management value chain know the scale of likely changes would free discussion, stimulate innovation and better serve customers. If the lack of this is deemed a market failure – and we think it is – then the FCA has a role in addressing it.

Conclusions

We would urge you to look more widely in your review and in particular to consider if the asset management market can cope with the likely changes in financial returns and customer demands which lie ahead. We think the current model, current fees and current margins are under pressure and it is more important to ensure the market evolves correctly than to focus unduly on these areas.

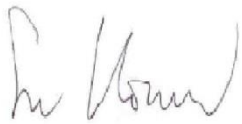
In terms of the approach of those involved in asset management we would close by quoting paragraph 6.24 of the Kay Review. Whilst referring to equity investment, UKSIF's experience is that it applies throughout asset management:

[3] And as you point out, DB trustees are required to take advice in certain areas of their work.

“Our very clear sense, after an extended series of meetings and consultations with those involved in the equity investment chain, is that the vast majority of people employed in it want to derive satisfaction from doing a good job: a good job in the sense in which we have defined it, which is developing a financial services system that promotes high performing companies and delivers good and secure returns to savers. Conscientious stewardship is, for most people, an inherently satisfying activity.” “[4]

We trust the above information is clear, but if you require clarification on any of the points raised please do not hesitate to contact us. Equally, we would be delighted to meet you to discuss our thoughts in more detail.

Yours sincerely,



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[4] The Kay Review of UK equity markets and long-term decision making, July 2012 available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf