THE
INVESTMENT
ASSOCIATION
INVESTMENT MATTERS

AE 2017 Review Team, Private Pensions
Directorate
Department for Work and Pensions
First Floor, Caxton House
Tothill Street, London
SW1H 9NA

The Investment Association
Camomile Court, 23 Camomile Street,
London, EC3A 7LL

T +44 20 7831 0898
E enquiries@theia.org
W theinvestmentassociation.org
Twitter @InvAssoc

Date: 22 March 2017

Dear AE 2017 Review Team

RE: Review of automatic enrolment – initial questions

The Investment Association welcomes the opportunity to provide input to the DWP's initial questions on the review of automatic enrolment. We attach below our detailed response to a sub-set of the questions posed.

The Investment Association has always been a strong supporter both of automatic enrolment and the creation of NEST as a way of helping employers fulfil their duties. The early phase of automatic enrolment has clearly been a success in terms of increasing coverage levels but more needs to be done in terms of raising contribution rates and increasing member engagement and we are pleased to see the review is considering these areas.

We also welcome the review of the default strategy charge cap which is taking place alongside the main automatic enrolment review. It provides an opportunity for the Government to consider evidence of the impact of the charge cap on the overall DC workplace pensions market as well as the services supplied to DC workplace pension schemes, of which asset management is one.

Asset managers invest the contributions of DC scheme members in a variety of different asset classes in the UK and around the world. These investments contribute to economic growth, which in turn generates the returns that help grow members' pension pots. We would encourage Government, and the automatic enrolment review process, to recognise the wider capital allocation function of the asset management industry, including the reality that index tracking depends upon active allocation decisions across financial markets by asset managers and others.

However, asset management in DC pensions is about more than returns. It is also about the management of risk and, in the environment created by the pension freedoms, the generation of sustainable income streams in retirement. Here again, asset managers have a significant and growing role to play.

While we recognise that questions of coverage and engagement are extremely important as well, our response focuses on two areas in particular – how to move beyond current

minimum contribution rates and the wider review activity on the charge cap and the implications for the DC investment landscape. Our response is in three parts:

- Contribution levels. We emphasise the importance of increasing contribution rates as a precursor of delivering better member outcomes, and recognise the potential role that behavioural mechanisms may have in achieving this. The central message is that while a focus on charges and disclosure, product design and governance is important, increased contributions are essential in delivering the standard of living that DC members desire in retirement.

- Criteria for charge cap review. We set out criteria that the Government should take into account in its review of the charge cap, taking the debate more clearly into a discussion about value for money and member outcomes as well as considering wider implications:

    - Pricing trends in the DC market.
    - Impact of the cap on default investment strategy design.
    - Performance and outcomes at the provider level.
    - Sustainability of pricing models in the DC market, concentration and competition at both the provider and investment manager levels.
    - Impact of the regulatory environment (including the cap) for DC schemes looking to invest their members' money.

    We present some initial evidence of the impact of the cap to date on pricing at the scheme level as well as the design of DC default strategies in the most cost-constrained part of the market. This evidence shows the dominance of passive investment. While passive has a role to play in the market, we are concerned that the cap may be increasingly driving a focus on cost rather than what is the optimal investment strategy to implement a given member objective. The danger of a lower cap is that it removes choice for those schemes wanting it and risks further exacerbating the lack of focus on designing optimal DC investment strategies.

- Definition of cap. We discuss the nature of transaction costs and explain why they should not be included in the cap. Investment managers should be incentivised and remunerated to deliver the best outcomes for clients, given the objectives of a given product or strategy. While charges behave in a linear fashion in reducing returns, there is no inherent connection between the level of transaction costs and the return delivered. It is not clear how mixing the two is consistent with good consumer outcomes, a point made by the Office of Fair Trading in its 2013 Market Study on DC Workplace Pensions.

I hope this response is helpful and I would be delighted to discuss it with you further.

Yours sincerely,

Imran Razvi

Public Policy Adviser

RESPONSE TO AE REVIEW – INITIAL QUESTIONS

ABOUT THE INVESTMENT ASSOCIATION

The Investment Association is the trade body that represents UK investment managers, whose members collectively manage over £5.7 trillion on behalf of clients.

Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks & shares ISAs.

The UK is the second largest investment management centre in the world and manages 37% of European assets.

More information can be viewed on our website.

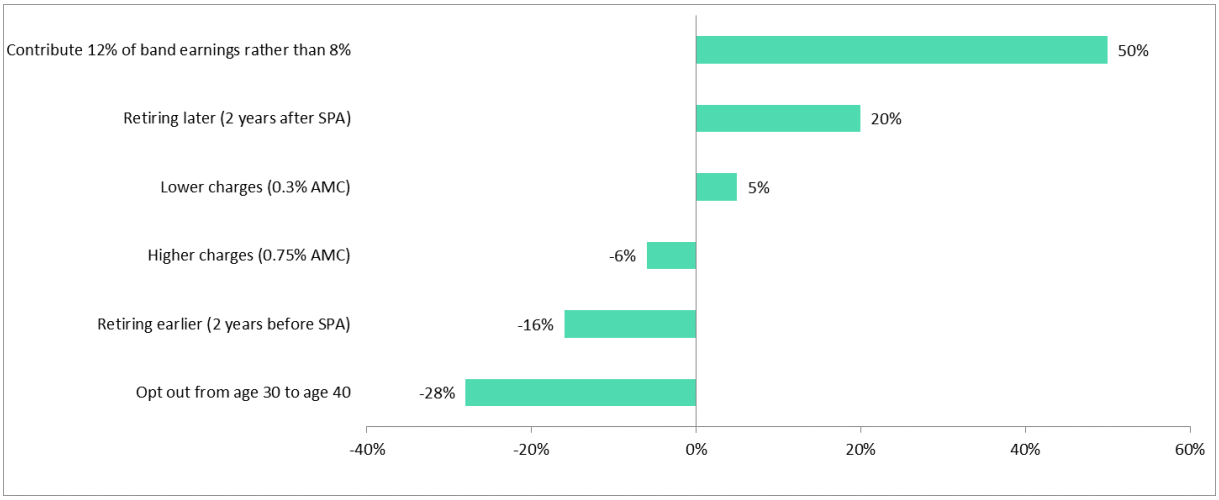
PART 1: THE IMPORTANCE OF INCREASING CONTRIBUTIONS

1. The Pensions Commission was clear that the 8% minimum combined employer and employee contribution recommended in 2005 was a baseline starting point. Contributions will need to rise in order for DC pension savers to achieve the living standards they desire in retirement. There remains widespread consensus around this point, with the debate centred on the required level of contributions and how best to achieve this whilst balancing the interests of employees, employers and the tax payer.

2. Product design, governance, the level of charges and transparent disclosure are clearly important factors, but a focus on these aspects of the DC workplace pensions market will not on their own deliver good outcomes for members. Work carried out last year by the Pensions Policy Institute[1] shows that the level of contributions is by far the most important factor in increasing retirement incomes.

[1] *Value for money in DC workplace pensions*, Pensions Policy Institute, 2016

Figure 1: Impact on private pension income for the median earning man reaching SPA in 2059, percentage difference from baseline



Source: PPI[2].

3. We recognise that there are a number of complex issues around the level and pace of future contribution rate rises. However, we think decisions in this area need to be taken now to pave the way for next steps beyond 2019. The length of time taken to implement the Pensions Commission original recommendations on a total 8% contribution rate underlines the need for long lead times.

4. DC savers will be best served by measures to help them save more which also recognise behavioural and informational obstacles to achieving this. Automatic enrolment to date has been a tremendously successful tool to help encourage pension scheme membership. Evidence from elsewhere in the world, notably the United States, suggests that other techniques, such as auto-escalation, can also be highly successful in the context of workplace savings. We would encourage Government to explore the use of these approaches in the next phase of retirement income policy.

5. At the same time, behavioural nudges are no panacea and should not be seen in isolation. Smarter communications, helping people to plan for their retirement, can also help build a new form of engagement. These are likely to be built not on abstract planning tools with multiple assumptions to plug in, but more sophisticated approaches, such as lifestyle visualisation. In other words, engagement is still going to be necessary but the tools for achieving it are likely to change. For its part, the asset management industry is committed to looking at the communication of the investment process to assess how firms can do more to explain their role and that of their products in a language that is more accessible and consistent.

[2] The individual is a median earning male age 25 in 2016 and, throughout his working life, earns at median age-specific earnings for a man. He retires at age 68 in 2059. Between the ages of 22 and 68, he and his employer contribute to a DC private pension. Charges are assumed to be 0.5%, and returns on assets assumed to be 6%. A 25% lump sum is taken at retirement and the remaining private pension pot is converted to a single life annuity.

PART 2: THE DC MARKET AND THE CHARGE CAP

6. We note that the cap has only been in place for just under two years, and has already had a significant impact on the market in terms of pricing and default investment strategy design. The cap has resulted in some schemes having to adjust their default investment strategies to comply with it. Asset managers have responded to the changing demands of the market by innovating on product design and pricing to reflect the conditions in the market – as we discuss below, this has largely involved having to build investment propositions very much with a budget in mind. This is a consequence of the cap changing the conversations with schemes and providers from what is optimal for the member to what can be achieved within the cost constraint imposed by the cap.

The Charge Cap – Criteria for Review

7. We think there are a number of criteria that the Government should assess when reviewing the level of the cap. In particular, it is essential to consider the level and quality of service provided. A debate about the charge cap ultimately needs to involve a wider debate about value for money, an area that IGCs and trustees are now increasingly focused on.

8. Evidence should be gathered that allows the Government to assess the impact in the following areas before coming to a decision:

   - Pricing trends in the DC market.
   - Impact of the charge cap on default investment strategy design.
   - Performance and outcomes at the provider level (linking to value for money).
   - Sustainability of pricing models in the DC market, concentration and competition at both the provider and investment manager levels.
   - Impact of the regulatory environment (including the cap) for DC schemes looking to invest their members' money.

   We discuss these in further detail below.

DC Market Pricing Trends

9. While it is sensible to review the impact that the cap has had following its introduction, we do not feel that it has been in place long enough to justify further change. The market needs time to settle down over a longer period before a proper judgement can be made. In particular, it is not clear what policy problem a reduction in the cap (or the inclusion of transaction costs within it, which also amounts to a reduction[3]) is designed to achieve.

10. The following tables are taken from DWP's own survey evidence[4] on charges in workplace pension schemes and indicate that charges for AE qualifying schemes are already well below the current level of the cap. The impact of the cap can clearly be

[3] Inclusion of transaction costs within the cap would mean an additional service now needing to be paid for within the cap. This effectively shrinks the budget for existing services that must be met out of the cap budget – hence an effective reduction of the cap. The issues with transaction costs in relation to the cap are discussed later on in our response.

[4] *Pension Charges Survey 2015: Charges in defined contribution pension schemes*, DWP, 2015

seen by comparing charges for qualifying vs non-qualifying schemes and charges for the smaller employers' schemes that have not yet had their staging dates to the charges on larger schemes whose employers have gone through staging.

Table 1: Average ongoing charges (% FuM) paid by members of each scheme type, 2015

	Contract-based	Master trust	Trust-based
Qualifying scheme	0.55	0.46	0.42
Non-qualifying scheme	0.81	0.60	0.67

Table 2: Comparison of average ongoing charges (% FuM), 2011-2015

	2011		2013		2015*	
Scheme size	**Contract**	**Trust^**	**Contract**	**Trust^**	**Contract**	**Trust^**
1-5	-	-	-	-	0.92	0.91
6-11	-	-	0.91	0.91	0.91	0.90
12-99	-	0.82	0.86	0.94	0.81	0.79
100-999	0.82	0.66	0.65	0.60	0.63	0.62
1000+	0.48	0.48	0.51	0.42	0.51	0.43

*Qualifying and non-qualifying schemes combined

^Excluding master trusts

11. Additional evidence on scheme pricing is available from a recent report[5] by the Defined Contribution Investment Forum on the master trust segment of the market, which reported that master trusts typically fell into two main categories in terms of charge levels – (i) member charges equivalent to 50 basis points or less; (ii) member charges at or just below 75 basis points. In the former category, in cases where the employer paid some of the scheme's costs, the charges for members even fell as low as 20 basis points.

12. For employers and schemes that wish to purchase cheaper options, the market is already providing these low cost solutions. Reducing the cap means that choice is removed from those employers and schemes that want to make use of the budget available to them within the existing cap. Those schemes priced at or just below the current cap would also be faced with the cost and disruption of re-designing their default strategy to comply with a lower cap.

13. We think the above evidence could be supplemented by a more disaggregated set of data showing the cost of the different components that make up a DC pension product. This will allow the Government to see the cost of these different services and how those costs are changing as a result of the cap. This in turn can then be assessed against the level of service/type of product delivered in order to understand at a more granular level how product quality and type is evolving in response to the cap.

[5] *Master Trusts: Investment Designs – A Comprehensive Study*, DCIF, 2017. See p17-19 in particular.

14. DC pension products involve the delivery of a number of services of which investment management is just one. Other services include administration and record keeping, communications and governance. In some parts of the market (typically the contract-based and master trust segments) the cost of all of these services must be met within the 75 basis points (bps) cap. To the extent that the employer subsidises one or more of these services, the 75 basis points may be used to provide a bigger budget for the services paid for by the member.

15. DC default investment strategies typically involve blending multiple funds and managers, asset classes, management styles and techniques over the course of the investment period. Schemes rely on the advice of investment consultants and in-house expertise for asset allocation and manager selection decisions; and on asset managers for a variety of services including asset allocation decisions, security selection and the implementation of risk management techniques. The decentralisation of scheme investment design means that there is little in the way of market-wide information available on default strategy designs. However, there is some evidence available in parts of the market

16. Where 75 bps represents the entire budget for investment, it is possible to design high quality investment strategies that offer access to both active and passive management products and services. Active management should be viewed broadly to include active asset allocation, access to a wide range of asset classes, risk management techniques and security selection. Of course this does not mean that the entire budget must be spent and as schemes choose to spend less on investment, the options on offer to them narrow until the cheapest end of the DC investment market is reached – passive index tracking funds in highly liquid developed markets.

17. Schemes typically make use of a variety of products and strategies, incorporating both active and passive management. For example, an active asset allocation strategy can and often does use passive funds as building blocks to provide exposure to different asset classes. This is a common demonstration of how DC schemes face a choice between how best to combine active and passive management rather than picking one over the other. The IA offers no view on the suitability of particular investment strategies or products – these are decisions for pension schemes to make and it is right that they have a range of choice to suit their budget.

18. In our view, although this choice currently exists the cap has already had the effect of changing the conversation away from what is optimal for the scheme member to what can be achieved given a fixed financial constraint. The danger of a lower cap is that the choice for those schemes wishing to spend more on their investment budget is removed entirely and this is a key reason why we do not support a reduction in the cap.

19. As seen in the DWP survey data above the fully-bundled parts of the DC market are seeing scheme level pricing at closer to 45-55bps, well below the cap. This means that all of the costs mentioned above must be met within this budget. Scheme administration is a relatively fixed cost and the consequence of this appears to be that investment costs are being squeezed more by the cap relative to other services. This can be seen by the increasing prevalence of passive products in DC default

strategies (evidence on this is discussed below). Again, the IA does not view the dominance of passive investment in this part of the market to be a problem per se. However, where this is driven solely by a desire to cut costs with little consideration of the merits of the product in the light of member-driven outcome objectives, this is a concern. The impact of the cap has been that in the more cost constrained segments of the market, the desire to cut costs has been the overriding factor.

20. In the fully bundled segment of the market[6], an entire product fee of 45-55bps, leaves, we understand, 10-20bps for the investment budget.[7] In this segment of the market, we highlight the following trends in DC default strategy investment design:

    - A dominance of investment in passive equities, particularly in bundled schemes aimed at smaller employers.

    - An overall dominance of passively managed funds with little in the way of active management.

    - Little in the way of allocation to alternative, and potentially higher-yielding asset classes that are accessed by other institutional investors.

21. A dominance of allocation to equities in the growth phase of DC investment is not surprising in and of itself – this is consistent with investment theory and the time horizon of DC savers, which together imply that a significant allocation to equities is the most likely asset class expected to deliver an appropriate risk-adjusted outcome for members. The choice between active and passive management or combinations of the two within this asset allocation decision comes down to the investment beliefs and objectives of scheme governance bodies and providers as well as cost budgets in light of the charge cap.

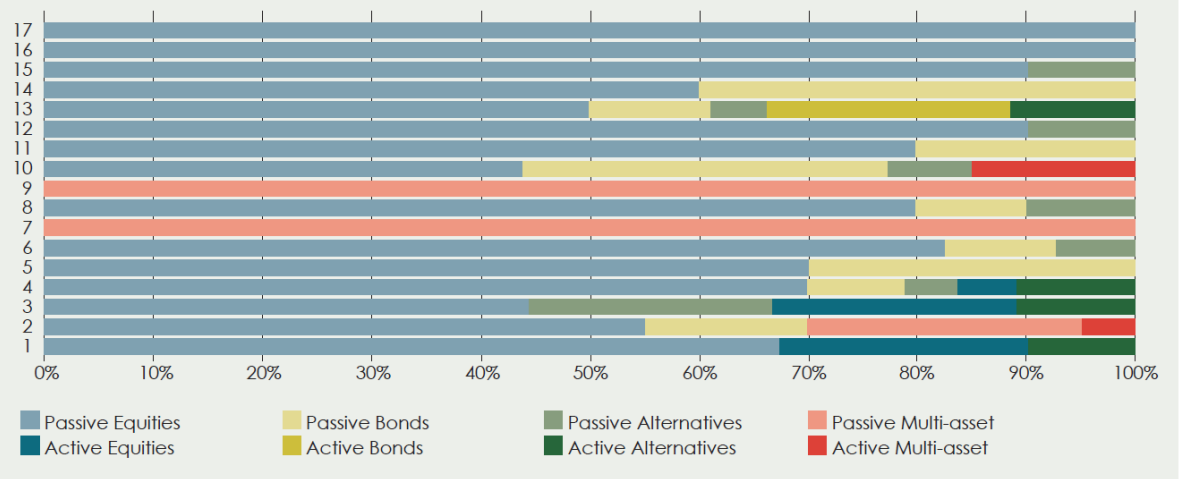
22. The use of passive management in developed market equities appears to be commonly based on a focus on cost over optimal investment design but in some instances also a belief on the part of governance bodies and providers that it is harder for active management to add value in this area. In this view the investment budget is better used in markets and asset classes where it is perceived as being able to add greater value – most commonly Emerging Market Equity, Debt and High Yield Bonds.

23. There is also a time dimension in that as members get closer to retirement, allocation to a greater variety of asset classes and markets increases due to the need to de-risk and reduce volatility of member account balances. This involves an increased allocation to actively managed solutions, although passive management remains dominant, with diversification still relatively limited given the lack of allocation to alternative asset classes.

[6] The source for evidence in this section is *Master Trusts – Investment Designs: a comprehensive study*, DCIF, 2017.

[7] This is corroborated by evidence in the DCIF report cited elsewhere in this section that the investment costs of many master trust propositions are in the range of 4-20bps (see p31 of the report).

Figure 2: Default investment strategy asset allocation for selected master trusts at age 45



Source: DCIF, Master Trusts – Investment Designs: A Comprehensive Study

24. This is consistent with the experience of IA member firms that describe the development in the DC investment market of a standard, low-cost investment consultant-led model where the growth phase is purely passive equities with greater exposure to active management options in the 5-10 years before retirement. At this point schemes might outsource some active asset allocation to managers through the use of Diversified Growth Funds[8] (typically 20-30% allocation of a default portfolio) alongside a more typical fixed income allocation.

25. One implication of the dominance of passive investment is that DC scheme members are fully exposed to market returns. While some scheme decision-makers may be comfortable with this, others may prefer a different route to risk management, including the use of active strategies. The danger of a lower cap – indeed a cap in general – is that decision-makers are no longer able to consider approaches that are optimal from their perspective, but only those that are allowed for in government policy. Anecdotally, this is not a comfortable position for many schemes. It is not without risk for government, regulators and industry over the longer term.

26. The logical conclusion of the trend is that there will be a point where the investment element can be squeezed no further and DC product offerings will have to shed other elements of member-value added service. These will be difficult decisions for DC trustees and product providers. Maintaining the cap at the existing level will avoid the need for such difficult trade-offs.

Governance, performance and outcomes at the provider level

27. This brief consideration of the evolution of DC default strategies in the most cost-constrained part of the market must also be considered alongside the governance processes that have resulted in their implementation. Here we are concerned that the cap has had the impact driving the design of default strategies with cost as the key determinant rather than identifying the investment strategy that is best for scheme members.

[8] Precise objectives vary across managers and funds but broadly DGFs are multi-asset funds that seek to deliver returns consistent with investing in growth-seeking assets, whilst reducing volatility compared with traditional growth-seeking assets.

28. Good investment governance is key to delivering good outcomes for DC savers. In an environment where outcomes are not guaranteed, a good investment governance process can enhance the likelihood of good member outcomes. This starts with the definition of a member-led investment objective and the design of an appropriate investment strategy to achieve that objective. Continuous monitoring of performance, fees and suitability of the strategy is required.

29. The IA has previously set out its views on the need for enhanced investment governance in the DC market and as long ago as 2014 we recommended the implementation of an investment governance 'MOT' for DC default strategies[9] which was designed to act as a checklist of minimum standards that all DC default strategies should meet. Much of the thinking in that proposal has now been incorporated into The Pensions Regulator's DC Code of Practice[10] for trustees and the guidance that sits behind it. In light of this it is concerning that the cap is driving a focus on cost over what is optimal for scheme members.

Performance and outcomes at the provider level

30. We note that the wider debate on the charge cap and value for money has focused little on investment performance and member outcomes and much more so on cost. The consequence of this is that cost and quality have often been conflated in that debate. We would like to see the focus move to performance and outcomes in the context of the costs that deliver them. Only then can there be a proper assessment on what constitutes value for money. While enhanced transparency of costs and charges in the DC market[11] will lead to consistent disclosure of costs, the same is not true of performance reporting.

31. The DCIF's work on the master trust segment of the market highlights the fact that there is currently a lack of standardisation in combining underlying fund performance in order to report at the strategy level. Greater transparency of default strategy performance reporting on a consistent basis will aid with the value for money debate. The pensions and investment industries should work together to define appropriate and standardised reporting metrics for DC default strategies and the Government should consider requiring reporting of the default strategy performance in Chairs' Annual Statements.

32. We do not see how an effective review of the charge cap can take place without information on the performance of DC default strategies – a focus on price that ignores the outcomes delivered risks not coming to a balanced conclusion. As part of its review of the charge cap the Government should therefore, where possible, seek information from pension schemes and providers on net-of-charges default strategy performance and consider this alongside the data it has gathered on scheme charges. Any justification for a lower charge cap would at the very least need to be grounded in evidence that outcomes from DC default pension products were consistently poor across the market in relation to the fees charged. Without having any data on outcomes we do not see how any serious judgement on the cap can be made.

---

[9] IMA response to *FCA CP14/16: Proposed rules for Independent Governance Committees*, October 2014. Available to download from the IA website.

[10] *Code of practice no: 13 – Governance and administration of occupational trust-based schemes providing money purchase benefits*, The Pensions Regulator, July 2016. Available to download from The Pensions Regulator website.

[11] In line with the rules in the FCA's *CP16/30: Transaction cost disclosure in workplace pensions*, October 2016.

Competition and Sustainability of Pricing Models In the DC Market

33. The DC market is highly competitive, both at the provider level and the investment management level. As has been highlighted above, competition has in some parts of the market pushed scheme level pricing down to a level well below the charge cap. Within that, price competition for investment management services has also been fierce, resulting in a dominance of passively managed investments at the cheaper end of the market, as has been demonstrated above.

34. At the top end of the market, up to the level of the cap, there are fewer constraints on investment design and accordingly, a greater range of products and providers at that level. Taking the market as a whole there are a range of products and providers operating at different pricing points in the market.

35. Reducing the cap will inevitably lead some providers operating at the top of the market to exit if they are unwilling or unable to serve the market at prices at or below the new level of the cap. With a large pool of other potential clients, firms may choose to look elsewhere since serving one market segment may come with the opportunity cost of not being able to serve other segments of the market.

36. In investment terms such an outcome will result in fewer asset managers serving the DC market. Schemes looking to access DC investment services will face a restricted choice set consisting of asset classes and markets that are highly liquid and relatively cheap to access, with management being done on a largely passive basis. This may have a number of consequences:

    - Increased exposure to market returns and reduced diversification of asset classes – the combined impact of which will be to see DC savers exposed to more market volatility than other types of investors that have the option of making use of a greater variety of asset classes and risk management tools. It may also increase issues of systemic risk as a large stock of DC assets moves in line with the markets.

    - Lack of access to some asset classes may result in a lower-returning portfolio.

    - A reduction in the number of investment providers in the market, further reducing choice and innovation.

37. This logic applies also at the provider level – greater price pressure leads to firm exits, less competition and innovation. Depending on how low pricing goes the sustainability of some existing business written by providers may become questionable.

38. The Government should therefore assess the impact of a lower cap on competition and innovation in the DC market – both at the provider level and at the level of service providers to schemes (including investment managers).

The Regulatory Environment for DC Investment

39. The Government has recently highlighted its desire to see pension schemes in general and DC schemes in particular invest in more infrastructure assets. There is no shortage of pension capital and a need to improve infrastructure in the UK. Wider pressure on public finances also raises the prospect of less public expenditure on infrastructure, with a need for private capital to step in. The Government is therefore right to ask the question of why DC schemes do not invest in infrastructure and the IA supports the Government's desire to boost DC investment in this area, alongside other alternative asset classes. We are currently carrying out

our own work on illiquid investments in DC and will be publishing a report later this year outlining the barriers faced by DC schemes looking to invest in alternative assets, along with recommendations aimed at optimising the regulatory and market environment for doing so.

40. As the DCIF notes in its report[12] *"[a]t the point that DB schemes start to de-risk and are unwilling to make long-term commitments to invest in infrastructure, the investment industry (and the UK) urgently needs DC pensions to replace these institutional commitments".* From a DC member perspective, infrastructure can both increase diversification and help generate greater returns, often through the existence of an illiquidity premium for not being able to sell the asset quickly.

41. As the DCIF notes "*[i]lliquid investments are essentially missing from investment designs….[in DC master trusts].. Some Master Trusts have direct property allocations, though these generally include some allocations to REITs to manage liquidity, and some underlying DGFs or TDFs hold illiquid assets as a part of their strategy. A wide universe of illiquid investment opportunities (property, infrastructure, private equity) are absent from most investment designs".*

42. There are a number of reasons why DC schemes do not invest in infrastructure assets, one of which is cost[13] – the charge cap already makes it difficult to invest in these assets as they typically come with higher costs associated with their management and the research required in assessing the case for investing in them.

43. Our concern is that Government's policy on the charge cap is not consistent with its stated intentions in this area. Given that infrastructure is already absent from DC default strategies we do not think that lowering the cap will help in this regard. On the contrary it will make it even harder to include infrastructure in DC default strategies.

44. This is in complete contrast to the Government's statements in this area. The Government should therefore, as part of its review of the cap, make an assessment of the impact of a lower cap on the wider environment for DC investment.

PART 3: TRANSACTION COSTS AND THE CHARGE CAP

CONCEPTS IN CHARGES AND COSTS

45. This section sets out our view of how product charges and transaction costs operate. The IA strongly supports the need to provide accessible, comparable and consistent information on product charges and transaction costs across all the markets and client groups served by its members. However, we suggest that regulators and policymakers should recognise the different way in which these operate and their impact on return. Combining charges and costs in a cap creates in effect a cap on investment activity which will not result in better consumer outcomes.

Service charges

46. Asset management operates on an agency basis. Charges are levied for the professional service provided, in the course of which the costs of investing in capital

[12] *Master Trusts – Investment Designs: a comprehensive study,* DCIF, 2017.

[13] There are also challenges created by daily pricing requirements imposed by investment platforms, the existence of the FCA's 'permitted links' rules and a lack of scale in assets on the part of DC schemes, which can make it difficult to invest in infrastructure due to minimum investment sizes.

markets are incurred. Other providers of financial services will levy their own charges relating to the service or product offered e.g. for financial advice or provision of a pension product.

47. Operators of pooled investment funds most commonly present their management charge through the Ongoing Charges Figure (OCF), which provides information on the product charge on an on-going and fairly predictable basis, in line with regulatory guidance on its detailed calculation. The OCF encompasses management fees as well as fees paid to other service providers such as the fund's custodian, auditor and regulator.

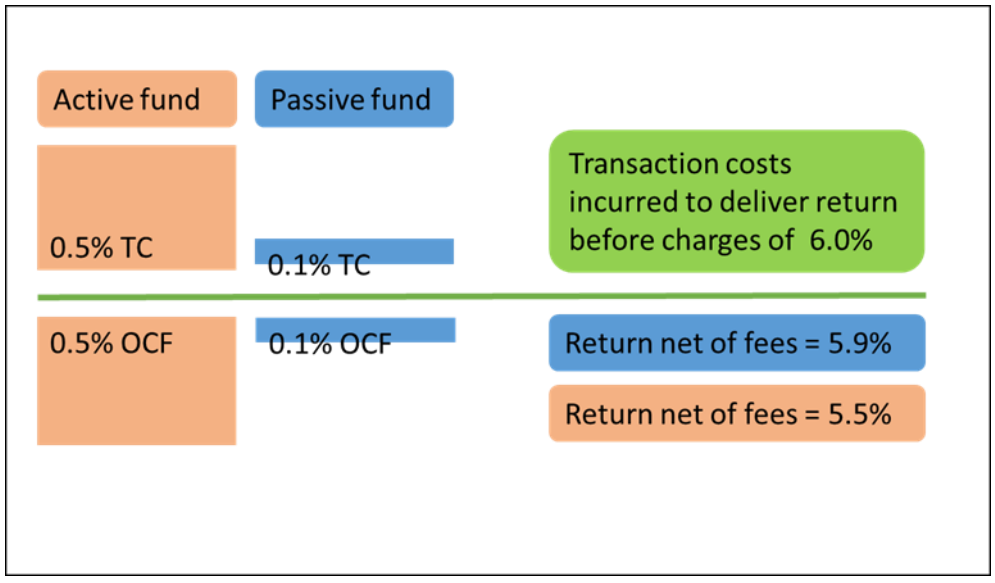
48. All things being equal, service charges will reduce the return in a linear fashion. In other words, a charge of 0.5% in a year will reduce the return by 0.5% in that year.

Transaction Costs

49. Transaction costs are incurred to gain exposure to the market or to change exposure in order to develop performance. They are the costs incurred by fund or portfolio managers buying or selling securities and financial instruments and arise due to the need for a market infrastructure that allows for assets to be moved from those who wish to sell to those who wish to buy. These buying and selling actions can arise because of investor flow, index rebalances, new investment ideas or ongoing risk management. Transaction costs can vary significantly across markets and across time, and will also depend upon how economic exposure is achieved. Appendix 1 sets out in more detail the different types of transaction cost.

50. Importantly, transaction costs are already captured within the return delivered by the asset management firm and should therefore always be viewed in the context of the return they generate and the investment approach followed. (see Figure 3).

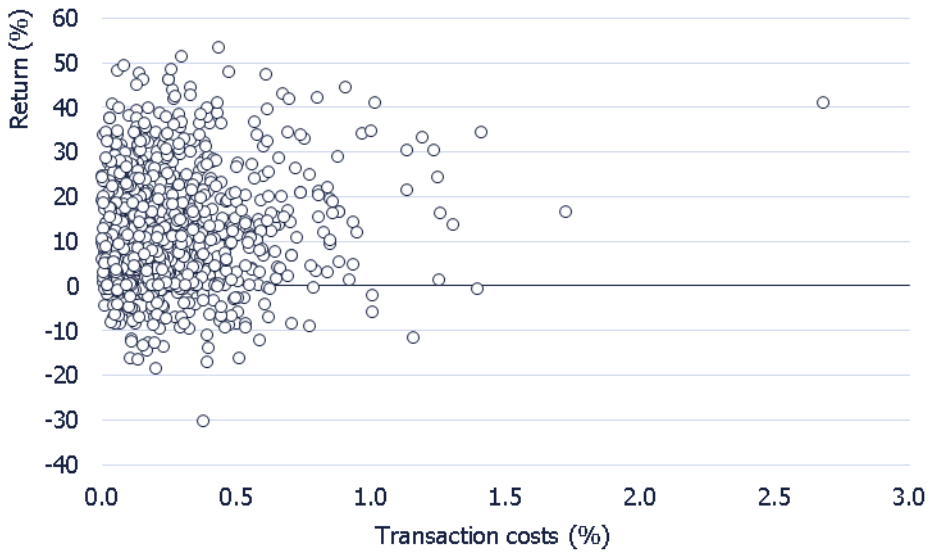
Figure 3: Effect of charges vs effect of transaction costs



51. Furthermore, transaction costs do not have a linear relationship to overall return. A higher unit transaction cost will reduce the return achieved from an individual trade. However, it is not necessarily the case that higher aggregate transaction costs will represent a greater drag on overall performance since the primary determinant of transaction costs is the volume of trading and the positions that result from that trading determine the overall performance. Conversely, lower aggregate transactions

costs will not necessarily result in better overall returns because the reason for the lower transactions costs could be a failure to make a trade which would have been performance enhancing. An individual fund could therefore incur high transaction costs and achieve strong or weak performance. Equally, low transaction costs could produce the same variation in returns. The point is, there is no causal link between transaction costs and performance – see Figure 4.

Figure 4: Annualised net return against explicit transaction costs, 2012-2015



Source: IA analysis based on Fitz Partners and Morningstar data

52. Thus two fund managers could incur considerably different transaction costs, but deliver the same return before fees. The nature of the charge will determine the net outcome.

53. Research that the IA published last year[14] on fund management charges, investment costs, and fund performance for a sample of active and passive equity funds from July 2012 to May 2015 found that, on an asset weighted basis, explicit transaction costs across the funds in IA equity sectors between 2012 and 2015 were 17 basis points (0.17%), the result of an average portfolio turnover rate of around 40%. Analysis of performance alongside this showed that funds covered both ongoing charges and explicit transaction costs and delivered returns higher than that of the relevant benchmark.

Enhanced Transparency of Charges and Costs – IA Disclosure Code

54. Investors should be able to see the charges they are paying for an investment management service as well as the transaction costs incurred in the delivery of their investment objectives. If used in the right way this will enable them to make informed comparisons of their managers and assess how effectively the managers deliver their service, in the context of what they are paid to do so. Such disclosure will aid meaningful value for money judgements.

55. It is for that reason that we are developing a new Disclosure Code, intended both to facilitate the intent behind the FCA's draft rules for transaction cost disclosure to the

[14] *Investment Costs and Performance: Empirical Evidence of UK Fund Industry Delivery*, IA and Fitz Partners, 2016

DC pensions market as well as to extend the coverage more broadly to allow all client groups access to enhanced information.

56. We will shortly be consulting publicly on a standardised disclosure framework and what this looks like will be set out in detail in that consultation, which is designed, amongst other things, to help asset managers fulfil their disclosure obligations to DC clients in line with the draft rules set out by the FCA in its CP16/30: 'Transaction cost disclosure in workplace pensions'.

Including Transaction Costs Within The Charge Cap

57. In our view, the inclusion of transaction costs within the charge cap will not result in better, transparently-delivered investment outcomes for savers. Our reasons for this are threefold:

1: Nature of transaction costs

58. As discussed above, transaction costs are necessary in order to obtain any form of investment return (including from tracking an index). It is not the case that high transaction costs will inevitably result in lower returns. A specific market or asset class may be more expensive to access, but scheme decision-makers may feel this is justified. While it is true that trading costs can harm net performance, this would result not from the quantum of trading per se, but inefficiencies in the trading process and/or poor investment decisions. We do not believe that consumers or scheme decision-makers would be well served by a restriction (in effect a hard cap) on how the investment process operates.

59. We remind the Government that the OFT offered this view in its 2013 report on the DC workplace pension market: *"We agree that fixing investment transaction costs within an AMC could limit the flexibility that investment managers have in pursuing transaction costs that are in scheme members' interests. Attempting to include transaction costs within the AMC could also undermine the objective of achieving a simple and consistent AMC breakdown. For these reasons, we should not seek to include investment transactions costs within a standardised AMC or total charge figure."*

60. Transaction costs are also different in nature to charges in that they are not paid to managers, but paid by managers in order to facilitate an investment performance which forms the basis on which they are measured and remunerated. At a fundamental level, there is therefore a clear incentive on a manager to transact in a way that is consistent with the best possible performance. Furthermore, managers are under a regulatory obligation to clients to ensure that they achieve best execution (this involves a number of factors including price, speed and likelihood of completion and settlement).

61. Finally, bringing transaction costs into the cap could create an accountability challenge in that poor performance could be blamed on transaction cost restrictions.

2: Operational challenges

62. An immediate practical issue here would be whether the cap is applied to transaction costs at total cashflow level. DC schemes are likely to be highly cashflow-positive for the foreseeable future. Any investment vehicle with strong positive cashflows, either actively managed or index-tracking, will experience significant transaction costs as it seeks to invest pension contributions. Indeed, in the UK equity market, it would be tax (stamp duty at 0.5%) and not brokerage that would be the main component of these transaction costs. To avoid this, Government would have to develop a methodology which attempted to cap discretionary trading activity.

63. However, a cap on discretionary trading (e.g. a total of 0.4% for investment fund charges and transaction costs within a cap of 0.75%) would see investment services priced in a way that is totally out of line with prevailing delivery and regulatory practice internationally. This may well significantly limit the opportunity set further for UK DC schemes, effectively restricting their choice to asset classes, markets and investment styles with low transaction costs, since it is highly unlikely that many asset managers operating pooled funds will wish to pre-commit to a cap on their discretionary trading activity, particularly if these funds are being used by non-DC investors as well. It is also unclear how changes in transaction tax regimes (e.g. introduction of a financial transaction tax) can be foreseen and built into expectations.

64. A further practical challenge is the consistent quantification of costs encountered in the financial markets. As shown in Appendix One, some transaction costs are explicit and captured in definitions used in international accounting standards: in the equity markets, broker fees and transaction taxes are clear costs incurred. In fixed income markets, by contrast, there are no explicit transaction costs, but there is a cost associated with trading in those markets. The Government needs to take care not to inadvertently introduce distortions into decision-making whereby transaction cost differences drive behaviour: e.g. towards asset classes with 'lower' transaction costs.

3: Sustainability of pricing at the scheme level:

65. We have presented evidence above that the cap has in some parts of the market effectively restricted scheme-level pricing to the 45-55ps level. Including transaction costs within the cap is the same as an explicit reduction in its level because it lowers the budget available to spend on other services that make up a DC pension product. There will come a point when pricing levels may simply not be sustainable for some providers to remain in the market – both investment managers servicing DC schemes and pension providers themselves. This will reduce choice, competition and innovation in the market, ultimately to the detriment of DC savers.

The Charge Cap, Transaction Costs And Manager Incentives

66. The debate around transaction costs being included in the cap seems to be driven by a view that asset managers benefit from incurring transaction costs and are not sufficiently incentivised to control them. This is not the case. High transaction costs that do not result in better outcomes will harm returns and returns are what managers are remunerated and judged on. So the incentive on managers is to minimise transaction costs for the implementation of their investment decisions.

67. In this regard there are a number of observations to make about managers' incentives to control costs:

- There is a key difference between the cost per trade and the aggregate cost of trading.

- Cost per trade relates to best execution requirements and there are limitations to what is within the direct control of the manager as well as a regulatory definition of best execution based on a range of factors and not only cost. However, within the best execution requirements, managers have both a regulatory obligation and an agency incentive to control cost per trade in order to maximise return. The question being addressed is: "Given the instruction to trade, are the costs being managed effectively?"

- The aggregate cost of trading is driven fundamentally by something different: the volume of trading. An incentive to manage aggregate transaction costs by reducing trading volume may compromise any given investment decision. Such a decision should be based on its potential to contribute to the overall net return and the positive impact of a trade is maximised by control of the cost per trade. While reducing the cost per trade will necessarily improve the return, trading volume itself has no intrinsic connection with return. High volumes may help to facilitate strong returns, or result in weak returns. The same is true with low volumes. This is illustrated in figure 4 above.

Controlling cost per trade

68. We recognise that best execution on behalf of clients is important. Furthermore, many firms invest significant resource in ensuring that these obligations are met. However, there are limits to the extent that fund managers can exert downward pressure on costs per trade. Although broker commission rates can be reviewed and negotiated, transaction taxes such as stamp duty, which are the most significant element within explicit costs of UK equity trading, are not within the control of the investment manager[15]. Moreover, independent research carried out for the FCA by Novarca in the context of the debate on transaction cost disclosure in workplace pensions notes that spread and implementation shortfall cannot be controlled directly by the investment manager given that they are an inherent part of a market structure[16]. While firms can take steps to identify the trading location that minimises the spread and implementation shortfall (whilst taking into account other requirements under best execution), they do not have the ability to control the overall level of these effects.

69. In its asset management market study interim report the FCA estimates that total equity transaction costs can add around 50 basis points[17] and broker commission is 17 basis points[18]. Therefore it would appear that currently only a third of the cost per UK equity trade is within the negotiable control of the investment manager – the remainder being stamp duty and implicit costs. In 2018, MiFID II will unbundle execution and research fees and require managers either to pay for research themselves or to charge clients a fixed research budget not linked to the value traded. Either way it will cease to be a transaction cost. According to ITG, broker commission rates in UK and Europe cluster around 2-6 basis points of the value traded for execution only services and 14-16 basis points for bundled services[19]. This implies broker commissions might be expected to fall from 17 to 5 basis points of net asset value and similarly total transaction costs might fall from 50 to 38 basis points. Overall, this would leave investment managers in a position to negotiate over one eighth of the cost per equity trade (5 bps out of 38 bps).

Trading volume and the nature of manager incentives

70. With such potentially limited ability to control the cost per trade, it may be argued that the only way fund managers can control transaction costs is to ensure there are fewer trades. Including transaction costs in a charge cap that cannot be breached,

---

[15] *CP16/30: Transaction cost disclosure in workplace pensions*, FCA, 2016. See section 3.8, p13

[16] *Transaction costs transparency*, Novarca, December 2014, p.15. Novarca use the term 'implementation shortfall' to represent the change in the price (i.e. slippage) between a benchmark price at the commencement of a transaction and the actual price at which it is executed. A number of different benchmark definitions are used for different purposes.

[17] *Asset Management Market Study Interim Report*, FCA, 2016. See para 1.29, p16 para 1.29, p.16.

[18] Annex 7 to the FCA *Asset Management Market Study Interim Report*, Figure 12, p.15.

[19] ITG Peer Analysis, Global cost review, Q4 2015.

amounts to setting a budget on trading activity that could incentivise investment managers to avoid trading in order to keep proprietary costs down. While some commentators would see this as a positive development, IA analysis has found aggregate turnover in funds to be far lower than often suggested[20].

71. More fundamentally, the IA has always argued that there is no incentive to over-trade given the nature of the current fee model: i.e. fund managers are incentivised to deliver the best possible return on a risk-adjusted basis, or a specific outcome in the case of more solution-focused products. Were the incentive structure to be changed such that transaction costs were included in a cap, our initial observation would be that there might be an increased risk of missed opportunities to make gains or limit losses on behalf of DC scheme members. In particular, if the effect of additional trading is to push asset managers beyond their trading budget for a fund and into a potentially proprietary loss-making situation, then asset managers might face a perverse incentive not to trade (to avoid making such losses) even though trading may be to the benefit of their investors. Ultimately such a cost structure could create irreconcilable conflicts between the asset managers' respective duties of care to their clients and their shareholders.

72. This is not just an industry view and we refer again to the OFT's conclusions in this area, cited above at paragraph 59.

ANSWERS TO SPECIFIC QUESTIONS ON WIDER REVIEW ACTIVITY

Q1: What are the advantages and disadvantages of lowering the level of the default fund charge cap?

See the material in Part 2 of our response.

Q2: What are the advantages and disadvantages of extending the cover of the charge cap to include some or all transaction costs?

See the material in Part 3 of our response.

[20] *Investment costs and performance: Empirical evidence of industry delivery*, Investment Association, August 2016.

APPENDIX 1: TYPES OF TRANSACTION COSTS

1. Transaction costs represent the total frictional cost of exchanging one asset (cash) for another asset (securities) based on the value of each asset at the point in time they are exchanged. For example, at a point in time, it might be necessary to spend £1,006 cash in order to buy shares with a mid-market value of £1,000 and cover transaction costs of £6.

2. Transaction costs can be divided into implicit and explicit costs. The latter can be identified by association to real cash payments from the fund or portfolio to some other agent. Implicit costs, on the other hand, cover a variety of impacts, not all of which are measurable with any high degree of certainty.

3. Explicit costs consist simply of:

   - Commission paid to a broker on the purchase or sale of securities.

   - Transaction taxes and levies paid to Governments/regulatory bodies or exchanges e.g. stamp duty levied on the purchase of UK equities.

4. Implicit costs are those that do not result from any fees being paid as a separately identifiable amount by one party to another. The most commonly encountered implicit cost is the bid/offer spread, the difference between the price for buying (offer) and the price for selling (bid) a security. For example, at some point in time, a fund seeking to buy a security might need to pay 100p and a fund selling at the same point in time might only receive 99p.

Table A1: Main costs of trading

Type of cost	Main features
Commission (explicit)	A fee paid to a broker on the purchase or sale of stocks or securities
Transaction tax (explicit)	Tax levied on the transaction (e.g. 0.5% stamp duty levied when buying UK shares)
Bid/Offer spread (implicit)	The difference between the price for buying (offer) and the price for selling (bid) a stock or security

5. The cost of translating cash into a financial instrument is not explicit but it is a real cost borne by investors which reduces the total amount of capital they have that is being put to work. Although no cash has been transferred by the fund for an identifiable transaction fee separately from the purchase price, a brokerage firm or an investment bank has earned revenue in the process.

Quantity of trading vs quality of trading

6. There is an additional category of implicit costs considered by practitioners of the Transaction Costs Analysis (TCA) discipline. These arise variously from the response of the market to any trading or known intent to trade and also from any impacts from the timing of a trade or a delay in getting an order to market once it has been decided upon by the fund manager:

- Market impact - placing a large order for a security can move the market price against a buyer or seller. Market impact can relate both to both one's own orders and concurrent orders placed by other market participants.

- Delay – the change in the market price in the time from order initiation (when the manager decides to buy or sell a particular security) to the point their order is placed in the market.

- Slippage – the difference between the price at the time an order is placed into the market and the price at which that order is executed.

- Opportunity – orders are either filled or partially filled. Where the order is partially filled there is a risk once the order is closed of missing out on the opportunity to participate in favourable movements in the market price in respect of the unfilled portion of the order.

7. These categories of implicit cost represent estimates of how well a given decision to buy or sell an investment is implemented in the relevant markets. What makes them different from the spread within the market is that these costs represent value lost (or gained when the price moves in the trader's favour) to the market as a consequence of how and when the decision to trade was brought to market. The cost of the spread, on the other hand, represents economic value transferred to counterparties transacting with the fund as a consequence of the actual execution of a trade.