Asset Management: towards a program for Treating Customer Fairly

Speech by Theodor Kockelkoren, board member of the AFM, at the DUFAS meeting at Wassenaar, 1st of June 2011.

1. 'Treating customers fairly' is the central theme since the credit crisis severly hit the trust customers placed in financial services firms. Especially banks are still in the cross hairs of society. As a result they have embarked on a journey for the trust of their clients. They are evaluating their products and distribution methods. The yard stick is whether they work for the interest of their customer. This yourney is not easy for banks nor will society let them stray away from it.

2. Asset Managers have not been put central stage, yet on stage they are. There is plenty of talk about the now lost confidence their customers once placed in their performance. There is considerable buzz about the fees and kick backs that straddle the gap between gross and net performance. Increasingly, the retail public is waking up to the drum beat that many institutional clients already march on: Costs not only matter, they ought to be top priority next to performance. At this point it slowly sinks in that both costs and performance are no indicators easily read off a meter.

A perfect performance picture?

3. Zooming in first on performance, a hazy picture comes in sight. From the perspective of the customer it is difficult to measure performance and it is even more difficult to predict performance. This leaves the customer in the hands of two financial institutions he or she has to trust: first, the distributor and/or advisor who he trusts to only select those managers that really add value, and, second, the manager who he or she consequently trusts to protect and/or grow his or her money.

4. Typically, three to five years of performance information is provided to customers – many funds do not even have a track record that is significantly longer. This is not enough of a period to base conclusions on for individual funds. Luck and skill of a fund manager can hardly be separated with any precision and confidence using such short periods. Sometimes a benchmark is not even provided, and where it is, it is not always clear it is the right one. For instance is a simple market weighted reference to

be used or a smart reference reflecting persistent behaviour of stocks (such as momentum)? Is the performance of a fund weighted for the possible additional risk it took compared to the benchmark? Often it is not and investors end up comparing apples and oranges when looking at their fund's past performance and the published benchmark.

5. To really add value is not easy. It requires skill and not only that, it requires sufficiently low costs to prevent the gains being eaten away. Academic literure does suggest that skill exists and every time we read about the sage of Omaha we are reminded of just that. We are also reminded of that question: where is the Buffet I can trust my money to?

6. The problem is that there is no widely available reliable indicator. Of course, institutional clients can with effort do their analysis and due dilligence, but the retail investor has to rely on cruder instruments. One problem is that persistent skill is scarce. The second problem is that skill, once the word does get out, is self defeating: the more money flows into the fund, the less likely outperformance will result (and more likely money gets parked waiting for superior investment opportunities). And the third problem, unfortunately, is cost. The outperformance is wiped out more often than it holds its grounds.

7. The issues just mentioned tend not to get noticed during bull markets: as long as the investment accounts rise everybody is happy. It is during the bear markets that people notice. For example, it was during the previous bear markets that US retail investors realized one of the biggest sources of underperformance was costs. The ETF industry is another example, it started growing fast during the dotcom crash and has accelerated further during the credit crisis. In the Netherlands increasingly the press is writing about fund performance. In March this year Het Financieel Dagblad reported that over half of retail funds are not outperforming their own choosen benchmark. Every bear market raises the bar for managers.

8. In Europe it took the credit crisis to really put the active versus passive debate on the agenda. Increasingly, institutional investors are choosing a conscience mix between passive and active strategies and no longer rely on active managers only. This is driven both by research into performance as well as opportunities to significantly

reduce management cost. "If I'm going to get beta returns from you, why should I pay alpha fees?" is a frequently heard rhetoric.

9. In the current market structure, retail investors too should think hard about their investment philosophy. Since distributors seem not to do a great job spotting the scanty skillful manager that will repeat their artistry year after year, investors are wise to reflect whether the core of their portfolio is not in better hands of a sound and low cost passive fund. Actually, some research suggests that the thoughtful energies of investors is better directed to their asset allocation as a function of their goals, position and risk appetite, rather than clubbing their head over which fashionable strategy to follow. More precisely, 80% of performance comes from a well choosen asset allocation, the remaining 20% flows from fund performance.

10. From the point of view of the fund industry, I think the above makes clear how important quality control is. Fund houses should direct considerable energy to ensure new to be introduced funds have a high likelihood of outperformance. It is probably wise to re-evaluate the performance of their current fund portfolio in the light of the more critical eyes of customers and stakeholders. Both actions need to be based on rigorous analysis. Helpful could be the suggestion of Ross Miller to estimate R^2 and the introduction of active expense ratio and the active alpha. Along a similar line of thinking the notion of active share and tracking error as introduced by Jeroen Cremers and Antti Petajisto could be instrumental as well. Both ideas try to establish relatively easy to determine indicators of the likelihood of outperformance.

Please, some enhanced transparency

11. Although it will be very difficult for investors to identify the persistently outperforming fund, I believe investors would nevertheless welcome some, well, enhanced transparency. Currently, they have to rely on a TER that is not a TER, they have no open and standardized way of evaluating past performance and they have no practical indicators for future performance.

12. The TER is a little bit a misnomer, as it is handicapped by not including trading costs among some other things. It could be enhanced by adding a proxy based on the

turnover rate of the funds. Especially in the past few years the trading cost have been significant. For example a fund with a TER of around 1,2% actually had total expenses of 2,9%. With more examples such as these, it is no wonder few funds outperformed the index in 2008. There are also the thorny tax and dividends issues. Taxes and dividends are treated rather differently depending on the fund and its tax location. The differences can be material but can only be determined diving into a lengthy prospectus and doing quite some deduction. Stock lending practices can also be relevant both to risk and costs, yet how a fund is dealing with these issues becomes only clear after parsing some prospectus legalese.

13. Turning to the transparency of performance, I acknowledge that the discussion on performance is rather technical, yet this does not help the retail investor. Fortunately, institutions as Morningstar do provide guidance. Morningstar used to have a method that did not predict particularly well, but has since 2002 employed an improved methodology that has demonstrated some predictive power. Nevertheless, the stars are indicative and, as it turns out, no better indicators that the Total Expense Ratio's. Recently, research by Morningstar themselves shows TER does the job similarly or even better than their stars 58% of the time. This raises again a question about performance: if both stars and TER are indicators of outperformance, why do we see so many three or two star funds and why are there so many funds with relatively high costs?

Cost: a significant challenge

14. This brings us at costs, indeed a central theme when deciding which funds to use. It is instructive to compare the US and European markets. For starters, one stumbles over the mountain of European funds, 33 thousand in 2009, having strolled past the 7600 funds in the US. This has not been always the case: in 1993 there were somewhat over 5000 funds in Europe. What's more, the average fund size in Europe has not really moved in ten years: in 2008 it was Euro 15,7 million, smaller than the average in 1999. Compare this again with the US where the average fund outsizes its European cousins with a factor of hundred.

15. These number and size differences do have an impact on costs. The average US fund fees are significantly lower than their European cousins. Typically fees in the US are well below 1%, whereas in Europe they tend to be 1,5% or higher. The difference in terms of reduced wealth accumulated over thirty years is significant: well over 10%.

16. Disclosure standards in the US, according to Morningstar, are higher. The whole picture paints the US as a more mature market that is better in tune with the interests of its customers. In the US it is government that is trailing some of its European counterparts. For instance, the Netherlands is doing better on regulatory and tax issues.

17. What is speaking for the US is the presence of institutions as Vanguard and people as John Bogle, who has been pressing the message of low cost already for many years. There is no equivalent in Europe. Of course, the scale of the US funds also explains some of their cost advantages. According to industry experts, the mushrooming number of funds in Europe is fuelled by the perception that a flow of new products is necessary to lure investors. In their view, fund houses have more become marketing machines rather than fiduciary institutions fielding the trust of their beneficiaries. Every possible investment trends get translated into new funds.

18. Another feature of the American market is the intense competition for investor dollars, where investors – as mentioned earlier – have a keen eye on costs. The prevalent open architecture enables this to some extend. In many European countries, open architecture is not or hardly available, although the Netherlands is a happier example. Nevertheless, also in the Netherlands distribitors hold the power in the value chain. They have ownership of the customer relation. So far fund managers have not found building their own distribution presence attractive enough. The result is that many retail fund managers are not really in touch with their clients. Worse, from their perspective, they are in the hands of distributors setting the charges for their distribution services.

19. Especially the latter is an important contributing factor to higher costs in Europe. Easily, of the 1,5% management fee, 80 basis points are payed out as `retrocessions´ to the distributor, whether the distributor performs an execution only, advice or

investment management service. Of course, the resulting higher management fee makes it much harder for the fund manager to outperform the benchmark.

20. The system of retrocessions, and in that sense the distribution structure, of the European markets is under scrutiny. In the press one critical article after the other is published. The UK has decided on a ban of sorts in their Retail Distribution Review. In the Netherlands, mr. De Jager, minister of Finance, has indicated he intends one way or the other to ban retrocessions in the Netherlands as well. It is expected that the European Commission will also propose a ban on retrocessions, at least in combination with advice or investment management services. It would be commendable if the Commission would include execution only as well.

21. Some observers in the Netherlands worry about the implications of a ban. They think distributors may reverse their open architecture and would focus on home made products and worse on home made structured products, by some seen as expensive and needlessly complex. Given the growth oppertunities in the Netherlands in asset accumulation, this would seem to be either an open invitation for the foreign fund managers to at last establish their own distribution platforms or for new entrants to do this for them. Also, distributors seduced to snap back to their old closed shop business model, would not only face scrutiny of society but also of the regulator. The old state does not particularly fit the notion of 'Treating customers fairly' now so widely professed in the industry.

22. Scrapping the system of retrocessions will provide the industry, especially the distribution side, also with an opportunity to rethink their pricing strategy. The current distribution price seems strangely out of tune with both costs as well as value. It lumps together complete diverse services as execution only and advice into one price proposition, where both costs and value differ significantly between both services. Appropriate pricing may reveal that the current value of what is called advice in the mass markets is rather limited. It could spark a renewed interest of the big distributors to create new distribution concepts relying to a higher degree on self assisted advice software. Such concepts would be able to offer the mass market more value without the need to significantly increase cost.

A 'Treating Customers Fairly' program

23. Let me summarize in conclusion. It is time the industry takes charge, and pushes ahead itself. It could do this by kick starting a 'Treating customer fairly' program for the asset management industry. Such a program could include:

    - Systematically re-evaluate the current portfolio of funds against the criteria of added value (past and future likely outperformance), cost, safety and understandability

    - Establishing standardized performance information that is simple and reliable (and based on appropriate benchmarks)

    - Eliminating risk elements within funds that are not evidently clear to customers and/or are not appropriate given customer expectations

    - Establishing enhanced transparency guidelines to make sure the TER really is an TER

    - Cleaning up the byzantine structure of funds in the market today, as a first step to improve efficiency

    - Scrapping the retrocessions, as a second step to reduce the amount of cost in the chain

24. Of course, such a program will require time, endurance and resources. It is possible that to remain sufficiently profitable aggressive cost cutting is required. Yet, it seems it is matter of time before this program is forced upon the industry. I hope the industry will take the initiative and not wait for European or national law making. The AFM would support such an initiative. I would like already now to wish you success with this endeavour.