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Briefing Note

80% OF THE FUND MANAGEMENT INDUSTRY IS REDUNDANT

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SUMMARY

The Financial Conduct Authority (FCA) is to be congratulated on its recent interim *Asset Management Market Study*. Its robust, independent and damning evidence skewers any justification that active fund management of listed assets is worth the candle.

The consequences for the asset management industry are potentially devastating, but radical surgery is long overdue. Its failings have serious implications for the health of the country's pension funds, reflected in Melbourne Mercer Global Pension Index. This shows the UK's pensions landscape continuing to slide down the global ranking.[1] In addition, the UK's defined benefit schemes now have the weakest funding position in Europe. Britain has the highest

[1] The Index scores each country's pensions landscape on the adequacy, sustainability and integrity of its publically funded and private pension systems. The UK gets a C+ grade and is now ranked eleventh (of 27 countries), way behind A-graded Denmark and the Netherlands.

proportion of company schemes (38%) flagged as being in the weakest 20% of their industry peer groups, and UK company schemes are also the most underfunded relative to revenues.[2]

Simplification is the key. In respect of listed assets, over any meaningful timeframe, passive management should be embraced. The Government, acting through the Department of Communities and Local Government (DCLG) as sponsor of the Local Government Pension Scheme (LGPS), has a great opportunity to exhibit leadership, in the interests of all members of funded pension schemes. It should resuscitate and implemented its May 2014 proposals that:

1. *all* of the LGPS's externally actively managed listed assets (some £85 billion at the time) should be moved to passive fund management; and
2. *all* "fund of funds", which incur multiple layers of costs, should be replaced by one investment vehicle for alternative assets, to be managed in-house.

The Government is in no position to enforce similar proposals on private sector schemes but, in light of the FCA's report, many would consider it irresponsible for them not to follow DCLG's lead. The FCA should be encouraged to meet DCLG to discuss the implications of its findings.

1. THE FCA RIDES IN

A few years ago the author wrote an article chastising the active fund management industry (and the consulting accoutrement). In light of the FCA's interim report, there is no need to apologise for reiterating what was written back then.

Evidence continues to mount that active fund management is underpinned by a web of meaningless terminology, pseudo-science and sales patter. For too long, active managers have been allowed to shelter behind their standard disclaimer concerning the long-term nature of investing. But the long term never arrives: it merely shuffles forward: there is never a day of reckoning. In the meantime, ludicrously expensive talent is deployed in the pointless pursuit of continually trying to out-perform one another. Worse, it is a giant negative sum game in which the savers pay the price, their hard won capital being persistently, and innocuously, eroded by high recurring charges and fees.

One consequence of this, as described by the FCA, is high operating profit margins for asset management firms, consistently averaging around 36%. The FCA contrasts this with the average margin of the FTSE All share companies, at some 16%. The FCA also commented on how charges for active funds have remained stable over time, whereas charges for passive funds have been falling in recent years. It also identifies price clustering for active funds for sale in the UK, and concludes that "*there is little evidence that firms compete on the basis of price.*" The FCA's conclusion is clear: competition is not functioning properly.

2. PERFORMANCE: NO CONSISTENCY

But what of the so-called "star" managers? Every quarter, F&C Fund Watch publishes consistency ratios measuring the proportion of funds in the 12 main IMA sectors that produced

2 ***Global pension underfunding concerns***; MSCI AGR Issue Brief, October 2016

top quartile returns each year, over the prior three years. In the third quarter of 2016, of 1,137 funds, only 28 consistently produced top quartile returns (i.e. 2.5%). Using blind luck, one would expect 18 funds to achieve this, which leaves only 10 fund managers, 0.9% of a universe of 1,137, who could legitimately claim that their success was down to skill.

Over the same three year period, only 161 funds (14.2%) consistently produced above *average* (i.e. top half) returns. Statistically, this includes 142 who would achieve this through luck, which leaves 19 funds (0.2% of the total) that performed through skill. The other 976 funds (85.8%) failed to achieve what should be considered a modest objective, that of delivering top half performance over three consecutive years.

The FCA report comments on fund performance, finding that:

- institutional active investment products, on average, outperformed their benchmarks before charges were deducted. After charges there was no significant return over the benchmark for institutional products;
- active funds for sale in the UK, on average, outperformed benchmarks before charges were deducted, but underperformed benchmarks after charges on an annualised basis by around 60 basis points; and
- there is little evidence of persistence in outperformance in the academic literature, but there is some evidence of persistent underperformance.

Data shows us that the dominant contributor to total returns is the asset class mix, not individual stock selection. In practice, as the FCA has now confirmed, many so-called active managers are actually "closet trackers". Once their high costs are deducted, the outcome of sub-index performance is no surprise. To misquote Sir Winston Churchill, never is so much being taken by so few from so many, and for so little in return.

3. INVESTMENT CONSULTANCY: POINTLESS?

Costs are controllable but, by and large, investment performance is not. This is not a recent revelation. Nobel laureate Daniel Kahneman: *"there are domains in which expertise is not possible. Stock picking is a good example".* And Warren Buffett: "*By periodically investing in an index fund, the know-nothing investor can actually out-perform most investment professionals"*.

The FCA's report supports these sentiments, stating that investment consultants are not effective at identifying outperforming fund managers. Perhaps this is because a stunningly small number of funds beat their peers on a regular basis, over any meaningful timeframe.

But the crucial point is that *at the start of any three year period, say, no one knows which funds they will be, including the consultants*. The mantra that "past performance is no guide to future growth" cannot be faulted.[3] Hindsight being useless, this is active fund management's Achilles heel, and the crux of the debate.

The FCA proposes to consult on whether to refer the investment consultancy industry to the Competition and Markets Authority (CMA). In light of the above, it is not clear how this would help clients. Apart from reiterating the benefits of diversification (by asset class, and market exposures such as currency and term), and giving consideration to liquidity needs, what else is there to say?

4. ON-GOING OPACITY

The FCA is also critical of the difficulty that clients have in monitoring their consultants, and holding them to account. According to the report, the information presented *"was at times difficult to understand and important factors were not always highlighted. This could lead to poor performance not being communicated or being easily disguised."*

The FCA is picking up on an all-too familiar theme, the industry's cultural attachment to opacity around fees and performance. It is often hard for clients to identify added value.

5. FIDUCIARY MANAGEMENT

The FCA has rightly raised concerns about the conflicts of interest in fiduciary management (consultant and fund manager being from the same firm). While this is important, it is not the key point, which is that the rise of fiduciary management consultancy is symptomatic of the abject failings of some of those with governance responsibilities. Resolve this, and there would be no need for (the growing) fiduciary management business.

6. AND WHAT OF THE LGPS?

The LGPS is a disparate collection of 89 predominately sub-scale funds (in England and Wales) with total assets of some £214 billion (March 2016): it is one of the world's largest occupational pension schemes. It matters.

In May 2014, DCLG, the scheme sponsor issued a consultation paper[4] proposing that:

1. *all* of the LGPS's externally actively managed listed assets (some £85 billion at the time) should be moved to passive fund management; and

2. *all* "fund of funds", which incur multiple layers of costs, should be replaced by one investment vehicle for alternative assets, , to be managed in-house.

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[3] Indeed, paragraph 6.46 of the FCA's report states that *past performance is not likely to be a good indicator of future performance.*

[4] ***Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies**, Consultation;* DCLG, May 2014.

These proposals emerged after extensive analysis of LGPS data.[5] This found that on average, across the 89 funds, any additional performance generated by active management of listed assets (relative to the benchmark indices) is insufficient to overcome the additional costs. The conclusion is that it is better to invest passively, tracking the appropriate index.

Total cost savings of £660 million per year were expected, and £6.6 billion over the next 20 years, monies that would no longer reach asset managers' pockets: ultimately, a saving for taxpayers. Predictably, the (deep pocketed) industry fought back and, shamefully, the proposals were shelved.

CONCLUSION: RESUSCITATE THE DCLG'S PROPOSALS

The FCA has laid bare the nonsense that is the active fund management of listed assets. It is time that DCLG's proposals were resuscitated and implemented, in what would then mark a seminal moment for *all* occupational pension schemes.

If private sector schemes were to follow DCLG's leadership, the implications would be profound. Millions of scheme members would benefit, and it would become apparent that we do not need 80% of the industry. The remaining 20% should focus on adding value in the unlisted asset arena that lacks the indices required by (passive) tracker funds to replicate investment performance: principally "alternative" assets, property and emerging markets and smaller companies funds.

5 See ***The Local Government Pension Scheme: opportunity knocks***; Michael Johnson, CPS, 2013, and ***LGPS structural analysis***; Hymans Robertson LLP, published 2014.

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He is the author of more than 35 influential pensions-related papers for the Centre for Policy Studies (all of which can be freely downloaded from www.cps.org.uk). He is occasionally consulted on pension reform by serving Ministers and shadow Ministers, the DWP Select Committee and the House of Lords Select Committee on Public Service and Demographic Change.

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