Investment News

Monthly Bulletin from the Insurance & Investment Team

February 2017

Last Month in Brief

Initial estimates from the Office for National Statistics ('ONS') show that despite uncertainty surrounding Brexit, the UK economy grew by 0.6% from October to December 2016. This growth was in part driven by the weak pound leading to high export growth. This feeds in to an overall estimate of 2% UK GDP growth for 2016 compared with 2.2% in 2015.

Following the inauguration of President Trump, the headlines this month have been largely dominated by news from the US and global markets (excluding the US) have fallen due to uncertainty surrounding the President's potentially destabilising policies. As a result, the FTSE 100 ended the month down, offsetting some of the earlier gains made due to weak sterling. Furthermore the US dollar dropped in value against the Euro this month after Peter Navarro, the head of President Trump's National Trade Council, stated that the Euro was "grossly undervalued".

Stronger economic growth and rising commodity prices have led to a rise in inflation across the UK, US and Eurozone. In Germany, Consumer Price Inflation reached 1.9%, close to the 2% target set by the European Central Bank ('ECB'). Expectations of faster US growth and higher inflation have resulted in German bond yields reaching a 12 month high. This may present a challenge to the ECB's quantitative easing program which is expected to further fuel inflation, with some commentators calling for a tightening, rather than loosening of monetary policy.

Chart 1: Equity Indices

Equity returns were broadly steady over the month

Chart 2: Sterling Credit Spreads

Credit spreads fell slightly over the month

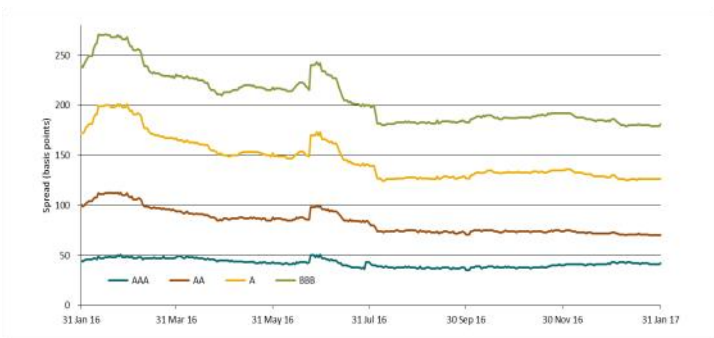


Chart 3: Gilt Yields

Long term gilt yields were broadly steady over the month

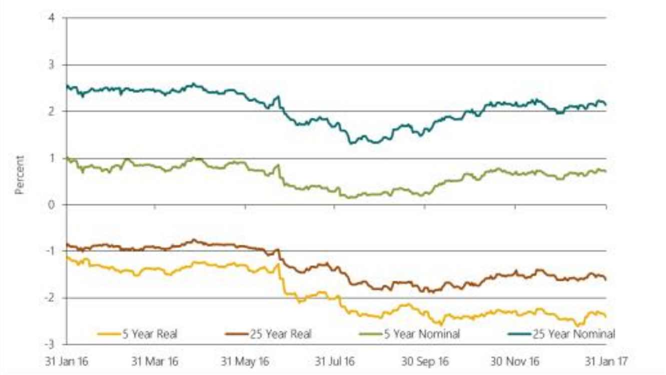
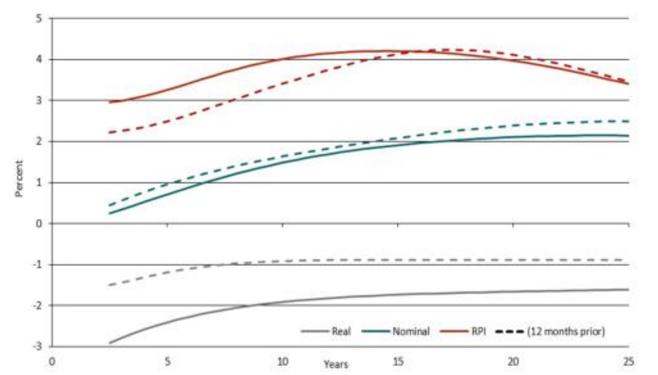


Chart 4: Gilt Spot Curves

The yield curve remains upward sloping



Source: Financial Times, MSCI, Merrill Lynch Bank of America, & Bank of England

	Latest	Previous		Latest	Previous
CPI increase (annual change)	1.6%	1.2%	**Base rate**	0.25%	0.25%
PPF 7800 funding ratio	86.8%	88.1%	**$/£ exchange rate**	1.26	1.23
Halifax house prices (monthly change)	1.7%	+0.8%	**VIX (volatility) index**	11.99	14.04

For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

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Asset Management Fees

Investment managers charge investors a fee to manage their money; in particular they charge for the expertise they provide and any administration costs related to the management of their portfolio.

Additional fees are incurred through the custody of the investor's assets and also due to explicit and implicit investment costs. The explicit costs include transaction costs incurred and the implicit costs cover the consequential market impact of the manager's trading.

In general, the fees depend on; the size of the fund, the assets held and the type of management required (i.e. active or passive management, *for further details see our September 2015 update where we discuss the difference between active and passive funds).*

It can be difficult for investors to know the exact fees they are being charged as not all fees, such as compliance and governance fees, are explicitly reported.

Investors also need to consider any conflicts. For example in recent years there has been a growing trend of investment consultants also offering fiduciary management services. This is where investment consultants provide advice but also actively implement their own decisions and manage the fund. This raises a potential conflict of interest as consultants charge fees based on their own decision making and management of the fund.

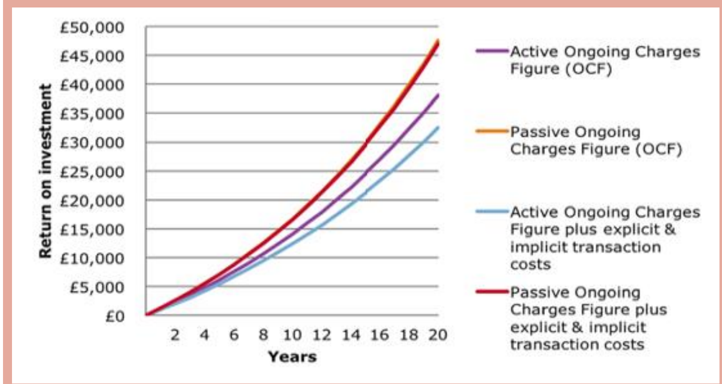
Can higher fees be justified?

According to Deloitte, actively managed equity funds in Europe charge a 1.5% annual management fee on average, whereas passive funds charge 0.6%. There can, however, be significant variation in these figures.

In 2015 the Government introduced legislation to cap the fees charged on default funds used for auto-enrolment purposes at 0.75% pa. These funds will therefore largely use passive management to keep their fees below the cost cap.

To highlight the impact of fees the chart below compares the net return on a £20,000 investment over 20 years for an active and a passive fund. The chart shows that, unless an active fund repeatedly outperforms the market, then its expected return can be significantly lower than that of a passive fund due to the higher fees (especially over the long term).

Figure 1: Returns on a £20,000 investment over 20 years



*Please note the orange line is hidden under the red line.

Source: FCA - Asset Management Market Study - Interim Report. November 2016

Why are fees in the spotlight?

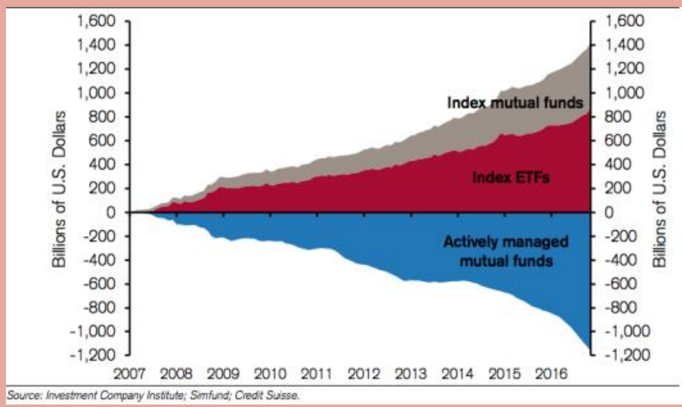
The Financial Conduct Authority (FCA) is the conduct regulator for financial services firms in the UK. They aim to make sure the financial markets work well so that consumers get a good deal.

The FCA recently produced an interim report investigating the asset management industry to understand the current level of transparency surrounding investment management practices.

The FCA found that actively managed fund charges have remained relatively constant for the last 10 years as few asset managers believe lowering charges would attract new clients. In contrast, passive investment charges have fallen over the last five years due to competitive pressures on investment managers as a result of passive investing becoming more popular.

Figure 2 shows the flow of money from actively managed funds to passive index funds including Exchange Traded Funds in the past 10 years, highlighting the increased popularity in passive funds.

Figure 2: Flows from Active to Passive Funds in US equities



What do the FCA propose to better protect investors?

The FCA has proposed a number of measures to protect investors and help develop their understanding regarding the fees they are being charged:

- Introduce an all-in fee (single fee covering all costs) so investors can easily see what is being taken from the fund.
- Require clearer communication of fund charges.
- Require greater disclosure of fiduciary management fees.

The Investment Association (IA), a trade body that represent UK Investment managers, has issued a formal response to the report produced by the FCA which largely welcomes its findings. The IA also acknowledged the renewed debate on the introduction of a singe charge in order to improve transparency.

How are Government involved?

The Government's commitment to requiring greater disclosure of transaction costs is reinforced by Section 44 of the Pensions Act 2014. This places a duty on the FCA and DWP to require the disclosure and publication of transaction cost information and administration charges.

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