INVESTMENT CONSULTANTS - MARKET INVESTIGATION

Summary of hearing with Baillie Gifford & Co (Baillie Gifford) held on 16 November 2017.

Growth of Fiduciary Management

1. Baillie Gifford was an asset manager (AM) which did not provide fiduciary management (FM) services. They managed money for a large number of Public and Private Sector Defined Benefit (DB) pension schemes, much of which historically came by way of an investment consultant (IC).

2. Baillie Gifford stated that there had been a change in the market dynamics due to the growth of FM, offered by both ICs and AMs and that this has led to a blurring of boundaries between these historically different types of provider. They believed that FM worked well for many schemes allowing them to improve their investment decision making.

3. They saw ICs as risk managers not asset managers, but, in their view, an IC effectively becomes an AM when it starts charging a fee for assets under management. They also saw ICs beginning to create investment products.

4. Baillie Gifford noted that many pure FM businesses have come from the Netherlands. The believed that Asset managers offering FM is a form of vertical integration which had more potential conflicts than when ICs offer FM, though ICs offering FM also have implementation conflicts.

5. Baillie Gifford believed that ICs have moved clients into FM without tendering, Baillie Gifford supported compulsory tendering for the first FM mandate and potentially for retenders. They also supported the use of Chinese walls within IC firms which offer FM.

Asset manager views of ICs and pension schemes

6. Baillie Gifford believed that the strength of pension scheme governance varies enormously. The growing number of independent trustees appeared to have helped although it is difficult for even experienced independent trustees to argue against the advice that a consulting firm provides, so they may not serve as an effective bulwark against the cross-selling of FM by consultants.

In general Pension trustees needed training – both ICs and AMs have their own agenda so this should be provided independently. The Pensions Regulator was working to address this but more detailed work needed to be done to improve governance.

7. Baillie Gifford noted that when ICs carry out manager selection, they tended to need a three year track record of a product in order to be able to recommend it. Baillie Gifford saw some potential ‘agency’ problems with the implementation of ICs’ manager selection activities, which are linked to timescales and the level of trustee education. For example, it is very hard for an IC to recommend a manager who has under-performed in the past one - two years even though this of a common characteristic of top-performing managers. So, ‘buy’ recommendations may tend to be for products which may were at the peak of their performance. ICs need to undertake the difficult task of educating and helping pension schemes to focus on the right things rather than second-guessing their preferences. In terms of research capabilities Baillie Gifford thought that manager selection could be done effectively by smaller, as well as larger, ICs as the quality of the research and experience of personnel involved is as important as its scale.

8. They noted that the DC pension scheme price cap had created a focus on all-in fees and that the pricing point of admin services was such that active management was all but crowded out. They did not think this necessarily meant good value for money for those schemes.

9. For AM fees, there was generally a tiered fee scale. ‘Most favoured nation’ clauses also existed. The effect of a price negotiation could go wider than one investor and different AMs may had different levels of price flexibility so it’s hard to know what actual fees are being paid by institutions. They noted that active product fees are generally under pressure and that the use of passive products and internal management is growing. They thought that transparency on both cost and value for money relating to all aspects of the savings chain was the best remedy to being about informed value-for-money based decision making.

10. There could be a conflict for FM providers who provide a bundled service comprising proprietary services and services provided by third party AMs. The effect being that there could be an incentive to spend a large part of the overall client budget on the FM’s internally provided services at the expense of external providers who may offer value-added services (for example, active investment management). Baillie Gifford noted a higher use of passive funds within FM than has traditionally been observed in traditional pension fund arrangements.

11. Baillie Gifford had been working closely with the Local Government Pension Scheme on their Code of Transparency. It supported moves to greater fee transparency to help Pensions Committees better understand the true cost of investment, its likely impact on performance and thereby assess value for money.

12. Baillie Gifford noted that many FM providers had appeared to have achieved a good result for their clients largely due to the use of LDI hedging rather than necessarily by superior performance on the asset side. They are aware of the work being undertaken by IC Select and Cardano on FM performance standards and support the development of much greater FM accountability.

13. Baillie Gifford stated that there should be clarity and an unbundling of the fees charged by FM to allow the trustees to better understand the proportion of their cost budget which is allocated to risk management, liability driven investment, asset allocation etc. and the balance that is allocated to investment implementation.

14. Unbundling and overall greater transparency will lead to trustees being in a stronger position to assess value for money and make appropriate comparisons between different FM providers.

15. Baillie Gifford said that Pay-to-Play (where Consultants charge an ad valorum fee for AM search activity to the winning Manager) began to be used eight - ten years ago and has grown a lot, although it is now effectively banned for retail investment (post RDR). If Baillie Gifford participates in this type of search they will visibly recharge the ad valorum fee levied by the IC back to the Client. They see it being used by one of the large ICs and some other firms. They also believed the scale of assets in Pay-to-Play could be as much as £100bn. Pension schemes may have preferred it as, the fee then comes from the assets, rather than as a professional services cost. It was less common in FM as the scheme performance is more transparent.

    Pay-to-Play leads to restricted access to the universe of AM. The cost of each pay-to-play search has risen dramatically over the years, so an increasing number of managers will drop out of participating. Pay-to-Play over time therefore reduces choice, increase cost and likely leads to sub-optimal investment outcomes.

    Baillie Gifford would support a ban on Pay-to-Play bringing it in line with the practice in the Retail market.

Conflicts

16. Baillie Gifford recognised that there could be a correlation between the level of gifts and hospitality between an IC and the number of buy ratings and common clients. This is correlation not causation. Baillie Gifford don't believe that gifts and hospitality have any effect on manager ratings. In the past, there were major hospitality offers around (overseas sports events, etc) but these have been quashed by FCA regulation, MiFID II will limit this further. Now, it may just be a dinner with an 'educational' element to it.

Regulation

17. Baillie Gifford stated that giving the FCA greater powers would compel ICs to act in their clients' best interests and other general aspects of the FCA 'code of conduct'. This would ensure that there is a clear fiduciary duty on the whole pension investment value chain, with an expectation of regulatory review if compliance does not appear good.

18. They support the inclusion of Master Trusts in the CMA's investigation with a similar focus on the unbundling of fees to allow Trustees to understand the costs of individual components and thereby be able to appropriately assess value for money.