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Analysing conflicts of interest in organisations offering both fiduciary management and investment consultancy services to the same client

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12 December 2017

1 Introduction

1.1 During a hearing on 27 November 2017, the CMA expressed an interest in our views of how it might be possible to analyse various potential conflicts of interest in organisations offering both fiduciary management and investment consultancy services to the same client ("Bundled Providers").

1.2 Accordingly, this document sets out areas where there appears to be the potential for such conflicts of interest giving rise to adverse effects on competition, and in respect of each identifies specific research, including quantitative tests, to examine the extent and severity of any such effects.

1.3 As a preliminary point, we note that the subtle nature of some of the conflicts we identify may mean that they could be overlooked by even reasonably sophisticated customers and fall outside the scope of independent advice where this is taken. In that case, these conflicts could arise and cause adverse effects despite the presence of reasonably high levels of potential competition in the provision of fiduciary management services at the time of sale and the scope for trustees to take external advice.

1.4 In the table that follows, we set out a range of potential conflicts and, in respect of each, a description of how it arises and our suggestions for the specific questions and in some cases quantitative exercises the CMA could address to investigate it. Key quantitative exercises are highlighted with a [*] below.

The potential conflict	Description of potential issue	Area we suggest the CMA investigates
[1] Setting a "soft" risk/return objective for the purpose of benchmarking the fiduciary manager	The Bundled Provider may have an incentive to advise the trustees to set a low return objective for the agreed level of risk when setting the mandate for the fiduciary manager (or a higher than necessary risk budget for the return objective). In some instances, the client may not be able to judge that it is giving its fiduciary manager an "easy" performance objective because of the complexity of the mandate. This conflict could be partially managed by appointing an independent reviewer of the fiduciary manager and the mandate given to it. However, the conflict is potentially only fully removed by an independent investment consultant advising on services up-stream of appointing the fiduciary manager; i.e . advice on what constitutes an appropriate risk level for the overall scheme and what investment return objective is appropriate to meet the scheme's overall objective (such that fiduciary management is then clearly an asset management service and not an extension of investment consultancy services).	1.1 Are clients made aware that this potential conflict exists? 1.2 Is there evidence that Bundled Providers set themselves lower return objectives (a lower return per unit of risk) than those where the client is advised by an independent third-party? [*] 1.3 Are Bundled Providers structuring products that, on their own assumptions, would be expected to materially exceed the advertised return target?

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[2] Favourable assumptions used by Bundled Providers to set allocations to partial-fiduciary products	Assuming that fiduciary management is a higher margin business than investment advisory services and that the margin increases further with the scale of assets on the fiduciary platform, there is a potential risk that, in advising on strategic asset allocation, Bundled Providers tilt assumptions to favour asset classes where they offer partial-fiduciary products leading to higher allocations to these products. The client may not be able to recognise this conflict because of the complexity of strategic asset allocation modelling.	2.1 For Bundled Providers that offer partial-fiduciary products, are fiduciary-clients' portfolios overweight in asset classes where the in-house product is used compared to advisory-only clients that do not use the in-house products?[*] 2.2 Are the asset-class assumptions used by a Bundled Provider for their fiduciary products, consistent with those used by investment advisory only firms, or is there a bias towards higher risk-adjusted returns for in-house products?

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[3] Only recommend one approach for a given asset class or being overly prescriptive in favouring certain combinations of assets classes that align with in-house fiduciary products	A Bundled Provider may have an incentive to recommend only its in-house (partial-fiduciary management) product for a particular asset class or combinations of asset classes. This could have an adverse effect on open-market competition for asset management products. Recommending only the in-house product may be a suitable general approach for some clients, but also means the full universe of open-market products are effectively ignored. Such an approach may not take into account an individual client's particular circumstances. This may lead to a client having inappropriate concentrations in sources of risk, assets or underlying managers, if other elements of its portfolio overlap with the fiduciary manager's offering. It may also lead to unnecessary transaction costs as the client replaces its original portfolio with the fiduciary manager's portfolio with little change in the underlying assets or exposures. Being overly prescriptive about blending several asset classes in a pre-determined way may favour in-house products and unduly narrow the "field of vision" on competitor products that do not exactly meet the specifications. This may leave only the in-house partial-fiduciary solution as a viable option presented to the client.	3.1 Are partial-fiduciary clients aware that, Bundled Providers may not have considered alternative asset management products, or may not have sufficient access to research alternative asset management products due to being viewed by other providers as direct competitors? 3.2 Are risk and return assumptions for in-house fiduciary products different from, and more attractive than, risk and return assumptions used for similar open-market products in the same asset class? 3.3 When a Bundled Provider has an in-house fiduciary product, what is the approach taken to research competing open-market products? In particular, what approach is taken to researching third-party fund of funds? If only limited research of competing products is carried out, are clients made aware of this? 3.4 What approach is taken in researching multi asset class funds (that may be a viable replacement for blended products offered by the Bundled Provider)? 3.5 Is there any evidence of the Bundled Provider tilting the research resources away from competing open-market products?

The potential conflict	Description of potential issue	Area we suggest the CMA investigates
[4] Fiduciary managers have an incentive not to propose certain insurance solutions that reduce their assets under management	Bundled Providers may have an added incentive to retain the assets under fiduciary management as long as possible. This could lead the Bundled Provider not to raise with the trustees the option of insuring benefits with an insurance company product; i.e., of transferring the assets to buy an annuity from an insurance company. Advisory-only investment consultants also face a potential conflict in terms of loss of ongoing revenue, but the higher revenues from fiduciary management services, combined with their greater “stickiness”, arguably make the conflicts more acute. Since the conflict arises from timing, it is subtle and may be hard for clients to detect.	4.1 Do Bundled Providers demonstrate a lower propensity to recommend buy-out/buy-in insurance policies across their entire client portfolio relative to advisory-only investment consultants?[*] 4.2 How many fiduciary clients of Bundled Providers have insured benefits with insurance companies (buy-in or buy-out)? How does the number of these transactions compare with those clients who take independent investment consultancy services?
[5] Conflict over advising a client that it should replace its fiduciary manager and transparency over sources of underperformance	Bundled Providers may be unlikely to recommend that a client review or replace the in-house fiduciary product. The overall returns could potentially mask underperformance in certain areas of management. Where those areas are the sole responsibility of the Bundled Provider, there may be a temptation to downplay the significance or even fail to comment on them at all. Even sophisticated clients may struggle to separate the full list of roles and responsibilities in fiduciary products. This conflict in isolation might be capable of being managed by the appointment of an independent adviser to oversee the fiduciary management mandate.	5.1 Where underperformance is attributable to the Bundled Provider, are there differentials between the period of time or magnitude of underperformance tolerated compared with third-party products?[*] 5.2 Does the Bundled Provider automatically report a full attribution of returns, clearly identifying sources that are attributable to the in-house team from those achieved by third-party managers? 5.3 Is the approach taken to monitoring in-house products consistent with the monitoring of third-party products?

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[6] Incentives to convert clients from advisory-only to fiduciary create conflicts	Teams or individual consultants may be given targets to increase the revenue from their book of clients, with their bonus or progression being determined by revenue increases. Given the higher revenues generated by fiduciary management, this may effectively be an incentive to sell fiduciary products to a client. This may create conflicts arising from incentives to sell fiduciary products (full or partial) even when an advisory-only service or open-market products are equally, or more, suitable for the client. Oversight of the appointment by an independent adviser of a fiduciary manager may be restricted to commenting only on whether the in-house provider is suitable, or the selection of a fiduciary manager, and may not be asked to consider the appropriateness, or not, of using a fiduciary management service.	6.1 Does a fiduciary manager's organisation operate revenue targets for teams or individual consultants that, directly or indirectly, incentivise them to convert clients to fiduciary mandates?[*]

Other potential conflicts

The potential conflict below exists for all fiduciary managers, whether or not they also offer advisory investment consultancy services.

The potential conflict	Description of potential issue	Area we suggest the CMA investigates
[7] Increasing fiduciary product complexity to “lock-in” clients	Fiduciary managers may have a potential incentive to create more complex or less liquid strategies that are costly to switch to another fiduciary manager or to change to an advisory-only portfolio. Thus, although fiduciary management is competitive at the time of appointment, it may be highly insulated from any competitive pressure subsequently due to the great difficulties and costs in switching to another provider. This risk is not necessarily evident to clients, because there may be a lack of transparency over entry and exit costs of fiduciary mandates. The complexity of a fiduciary management mandate may hide that there may be cheaper and simpler ways to achieve a similar performance. To justify the fees charged for fiduciary management there may be an incentive to create complex portfolios and to actively manage them. These complex portfolios and the active changes made to them may not be beneficial to performance compared to a fairly simple mix of hedging and growth assets (e.g., by comparison to a client that had fully hedged interest rates and inflation and invested in a diversified portfolio of equities, non-government bonds and property).	7.1 What is the rate of switching from fiduciary managers to another fiduciary manager or to an advisory-only consultancy approach?[*] 7.2 How does this compare with switching rates for other asset management products? 7.3 Are fiduciary managers’ portfolio designs more complex than non-fiduciary managers’ portfolio designs? Perhaps measured by using the number of asset classes and managers as proxies for complexity.[*] 7.4 Do Bundled Providers highlight potential costs and risks of unwinding such complex portfolios within their advice? 7.5 Have the fiduciary manager’s active asset allocation views added value across the entire portfolio?