Project Manager
Investment Consultants Market Investigation
Competition and Markets Authority
Victoria House
Southampton Row
London
WC1B 4AD

22 March 2018

Dear Sir

Investment consultants market investigation
Response to the Competition and Markets Authority's Working Paper on Information on fees and quality

Introduction

EY LLP has provided advice on investment governance solutions in the UK since 2010. A large part of this work involves providing independent oversight to trustees in advising them on the selection and monitoring of fiduciary managers. To date, we have been engaged by trustees on UK pension scheme fiduciary management mandates with AUM in excess of £20 billion.

In order to remain independent and free from conflicts of interest, we do not provide a trustee investment consulting service. We are also agnostic on the investment governance model chosen by trustees, whether advisory or delegated through fiduciary management. This independence enables us to obtain unencumbered access to sensitive information provided by fiduciary managers such as operating models, fee information, risk monitoring, solution construction, etc.

Our independent oversight service has evolved to address trustees' concerns and has resulted in our clients having fewer surprises in relation to fees and service quality. We believe strongly in helping trustees to define success factors and investment beliefs up front, to help ensure that selected fiduciary managers and their propositions align with those beliefs. This is a key starting point on which to build transparency into the contractual terms - including fees - which trustees enter into with their chosen fiduciary manager.

We believe that clear accountabilities should apply to trustees, as well as investment consultants and fiduciary managers in order to address both the supply and demand sides of the equation. Focusing on investment consultants and fiduciary managers will help but will, on its own, not bring about the necessary change quickly enough.

In response to the working paper on fees and quality, we have drawn on our experience in helping clients to understand the details of the service they are buying, and how best to monitor that service relative to their success factors.

Overarching principles

Explicit definition of buying criteria

There can be a lack of clarity on what trustee boards really want and need when buying investment services. We believe that all trustee boards should be required to produce a Selection Dashboard before conducting any vendor selection exercise which sets out clearly aspects such as their mission, objectives, investment beliefs, risk and return targets, de-risking plans, risk tolerances, conflict of interest policy, reporting requirements and service quality expectations. Having a clear purpose then allows the trustees to be clear on their own specific requirements.

Addressing both supply and demand aspects

Addressing the supply side of investment service provision on its own will be sub-optimal unless it happens in conjunction with the demand side whereby trustees are measured and held more accountable too in relation to how they respond and action advice or how they monitor what they choose to delegate.

Whilst the CMA review is focussing on accountabilities of investment consultants and fiduciary managers, we believe similar responsibilities need to be placed on trustees in order to get the balance between the supply and demand sides of the equation. In particular, trustees who decide to execute their investment strategies themselves by engaging on an advisory basis should have the same responsibility for reporting on all aspects just as fiduciary managers do, including clarity on fees and value for money.

Objective decision making

While we appreciate that choosing a consultant or fiduciary manager needs to factor in some subjective and less definable areas such as personal chemistry, we believe that on occasion insufficient attention is given to the hard facts around the ability and capacity to deliver the service.

To ensure that a high level of objectivity is retained in the trustees' decision making, we feel that trustees should be required to document why they have selected a given advisor against their Selection Dashboard, thereby capturing objectively what information was used to choose the preferred provider and what actions the trustees took to validate that information.

Improvement of fee information for current and prospective clients

EY strongly advocates fee transparency and has, for a number of years, published a bi-annual report on the costs of fiduciary management (latest copy attached). An important complement to this work is training trustees to understand different fees and costs in the value chain, and the impact of different fee structures on incentivising the recipients of those fees.

We see clients being able to compare providers and make transparent decisions regardless of providers' different fee structures. EY's standard Request for Proposal from fiduciary managers asks for a breakdown (shown below) of fees and expenses incurred by the fiduciary manager and, importantly, underlying investment managers.

- Base service fee (fiduciary management / advisory)
- Performance-related service fee
- Investment strategy advice fee (if not included in base fee above)
- Liability hedging fees (if not included in base fee above)
- Fee from internally managed funds
- Pooled fund expenses in respect of custody and administration (including fees deducted at source)
- Underlying investment manager base fees (including fees deducted at source)
- Underlying investment manager performance fees (including fees deducted at source)
- Underlying investment manager pooled fund expenses in respect of custody and administration (including fees deducted at source)
- Transition management fees
- Third party custody and administration fees
- Independent performance measurement fees
- Fees for legal review of investment manager documentation

A template should be made available that sets out all the fees and expenses trustees need to be aware of. Trustees would then have the responsibility to find out each of those costs from their advisors. Where information is not made available, trustees should disclose the reasons why that information is not available and how they have factored this into their decision-making.

Care needs to be exercised, however, to ensure that using a fee template does not bring about other unintended consequences. Standardisation of fees works where solutions are also standardised. There is a very wide range of different solutions provided by fiduciary managers in the UK, influenced by the very different needs of pension schemes and their sponsors. There is a real risk that standardisation of fees results in fiduciary management being perceived as a commodity, whereas it should be customised depending on individual clients' circumstances. We believe that standardisation of fee reporting and an onerous requirement to monitor fees could lead to trustees seeking solutions that are low cost, even though such solutions may not be in the best interests of the pension scheme. Fees need to be viewed in the context of the scope of service and breadth of solution to avoid such unintended consequence taking place. As such, monitoring of fees alone should not be done separately, but rather trustees should be able to understand, monitor and disclose what value they are getting from each element of the fee. Value can take a number of forms including improved risk-adjusted returns, lower operational risk, access to different asset classes, improved reporting and so on.

It is imperative for trustees to have responsibility on disclosure, as it encourages their understanding of fees and costs. Advisors and investment managers should then have a requirement to provide this information to trustees. Fiduciary managers are already finding it easier to provide this information on the back of MIFID II implementation.

Improving information on scheme performance

We believe there is merit in standardising the principles of reporting performance, however there needs to be the ability to customise content and style of reporting to meet client requirements.

As mentioned earlier, trustee boards should have clear objectives, risk and return targets and broader Selection Dashboards as part of their ongoing governance. The responsibility for providing this information should rest with the people who are in charge of executing the trustee board's investment strategy.

Fiduciary managers should (and largely do) take this responsibility of reporting performance to their clients. In the advisory framework, trustees take on the executive functions, and the responsibility of reporting on their actions should sit with the trustees.

Given that schemes, advisors and fiduciary managers operate differently, we do not believe that information requirements should be standardised. However, all trustee boards should be required to have very clear descriptions of their objectives (different funding targets over different time periods), risk and return and broader requirements. Once these are stated, it should make it easier for trustees to ask the right questions of their agents.

Performance metrics for prospective clients

Standardisation of past performance can be useful for trustees to validate whether the fiduciary manager has been able to deliver in line with expectations. Creation of a large number of composites allows fiduciary managers to group their clients in some form, and this may seem appropriate given the range of different mandates that fiduciary managers are able to create for clients. However, we believe it can create a number of challenges:

There is a need to understand all track records of a fiduciary manager

Whilst some track records may be more relevant to a given client situation, it is important to understand the performance of a fiduciary manager in the full range of services it offers. Otherwise, trustees may focus on a track record that is appropriate for now, but less so if circumstances change, making the past performance test redundant.

Understanding context and variables of each track record is necessary

There is a lot of variation around the construction of track records, particularly around investment beliefs, covenant risk and the broader factors that led to the design of that mandate. It is important that information around these factors are provided in addition to return targets and liability hedging ratios alone.

Documentation of the use of past performance

For years, the investment industry has been required to add disclaimers that "past performance are not reliable indicators of the future." Care must be exercised to ensure that past performance measurement is viewed as a component of decision-making rather than the sole key driver. Adopting a standardised process within a service that is ultimately non-standardised could lead to a pension fund placing inappropriate or over-reliance on the specific performance measurement. To encourage the right focus we would suggest there is a requirement to document how past performance data has been used in selection or monitoring and what reliance has been placed on it in trustees' decision-making relative to a Selection Dashboard.

EY's preferred approach is to look at performance track records in relation to the criteria on the Selection Dashboard. Fiduciary managers should then provide performance records across all clients on the same basis. The information listed below, equally weighted across all clients, can provide a reliable comparison:

a. Return on assets
b. Return on liabilities (or suitably defined benchmark) + outperformance target
c. Volatility of returns relative liabilities / benchmark + outperformance target

In addition, we believe that understanding the attribution of performance is equally valuable to the headline performance number, as trustees can relate that attribution to the fiduciary manager's investment philosophy and compare to the criteria in the Selection Dashboard more effectively.

Looking forward is just as important, if not more, than simply looking at a track record. Fiduciary managers are able to provide statistics of expected future return and risk of their portfolios as part of their proposals. Considering the future performance expectations in tandem with both past performance measurement risk attribution can give trustees much more confidence than the construction of that track record which might not match their own needs.

We hope our comments add to the important debate and would happily answer any questions or provide more detail.

Iain Brown
Partner and Head of Investment Governance & Oversight
Ernst & Young LLP
United Kingdom