CMA Working Papers – Asset manager product recommendations

Please find below the comments of Hyman Robertson LLP relating to the CMA's Working Paper: Asset manager product recommendations ("Working Paper").

As an over-riding comment, we would refer you back to our response to the Statement of Issues in October 2017, in which we argued that further analysis of the performance of active equity and bond managers would reveal nothing new. Pension fund asset allocation has shifted away from traditional equity and bond markets and, for equity and investment grade bonds, a much higher proportion of funds now use passive management. This is evidenced by only 10-20% of our manager searches now relating to active equity or bond management.

A. Comments on potential remedies (on page 53)

1. *Are trustees easily able to compare claims regarding impact of asset manager product recommendations made by different firms during a tender, for instance?*

We believe consultants are able to provide clients and prospective clients with a range of data around the performance of their manager picks. On the face of it, this is easy to compare, by looking at the level of outperformance. However, a number of factors, in our view, make this challenging and, at times, potentially inappropriate.

The main area we would highlight is that consultant recommendations combine strategic advice and implementation advice. Assessing one without the other can be misleading. In our experience there are a few asset classes where core recommendations represent a genuine selection from a wide range of similar possibilities. In these cases tracking a notional portfolio of recommendations seems a reasonable idea. In other areas, manager implementation is inextricably bound up with implementation of strategy, and detailed variations in the mandate. Here, aggregation of recommendations will conceal more than it will reveal. For example:

- While Investment consultants may have buy list of products for an asset class, these do, to some extent, also reflect historic preferences. Looking forward, they may not favour that asset class or seek to avoid it at a time when managers are likely to find it hard to add value in that asset class, and therefore have little or no client investment exposure to those products.
- A number of products are recommended not on the basis of outperforming, but delivering a benchmark return with lower volatility.
- Other products are recommended on the basis of delivering exposure to a particular asset class in a manner consistent with schemes' risk profiles, cash flow objectives and need for appropriate diversification, rather than to outperform a benchmark index.
- Most of the analysis provided in tenders is inclined to compare the products' ability to outperform a given benchmark (this was also the basis of the FCA analysis and has been repeated by the CMA). While this may be reasonable for a simple comparison of homogeneous equity managers, as mentioned above, there are now many different equity styles/factor approaches and many other asset strategies, which are not homogeneous and where such product comparisons will be misleading.

There are also further factors that can complicate the picture, particularly when looking at aggregate rather than specific data relating to differences in methodology. In tenders, one consultant may include all of their buy-rated managers, another may just include a small number of "best in class", while others will use a model portfolio.

However, subject to comments above about where comparisons may be relevant, it may be helpful to have a standard methodology as to how composites should be defined. On balance, a model portfolio of asset classes might provide a better source of information on which to measure the performance of a consultant's buy lists or preferences.

2. *Would trustees benefit most from information on returns achieved by recommended asset manager products on a gross or net basis?*

We believe there are pros and cons of showing performance gross and/or net of fees and thus we believe performance could be shown gross or net, but where gross, some comment on average fees or the typical allowance to be made for fees (either for an average scheme or reflecting scheme-specific circumstances) would be helpful in providing an indication of net returns.

In general a net basis is likely to be of most benefit to trustees, in showing the returns delivered net of all costs. However, when providing information in tenders, such as the consultant's ability to pick active managers, average returns will not fully reflect the tapering fee scales that would apply to a specific client's circumstances. Moreover, discounts will vary from client to client. Performance related fees just add to the complexity.

The one figure that will be common for investors in a product is the gross return. Measurement of a consultant's manager picks is cleaner and more comparable if calculated gross, but additional comments on likely fees, given the client-specific circumstances can provide prospective clients with enhanced information and would be good practice.

3. *How could the presentation of the impact of asset manager product recommendations be made more comparable, comprehensive, relevant and useful?*

Performance should be available over a reasonable time frame and different discrete and rolling time-periods (although if mandatory, we note that a longer specified timeframe would act as a barrier for new entrants). Performance should track a notional portfolio equally spread across all "buy" products for the period they hold the relevant rating. In our view, it is important to report by asset class and "buy" products should be restricted to a list of the length that clients would typically expect to see in a beauty parade short list.

A further factor that is relevant in assessing performance is the level of risk and this can complicate what might otherwise look like quite a straightforward comparison. For example, delivering higher returns in rising markets simply because a product is systematically adopting higher beta than the market is not necessarily an indication of management skill.

So, including a clear explanation of risk management approach is important, although, individual risk statistics, such as tracking error, can be misused or misunderstood as a measure of risk. This is perhaps best demonstrated where products focus on downside protection. This approach can give rise to a much higher tracking error against a comparable market index, but importantly for a client, can actually yield much lower overall risk when measured against their objectives or liability obligations.

This is just one example of why we believe it is important to reach broad agreement on the asset classes / strategies that are appropriate for aggregated analysis.

4. *What are the challenges of developing a common methodology? Should this be mandatory and, if so, should there be scope for divergence in specific circumstances?*

The key challenge of a common methodology is that not all firms focus on the same asset classes and areas for advice. As well as across asset classes, this diversity of approach also applies within equities and bonds – for example, some consultants focus on regional equity managers while others focus on global or factor-based managers. The provision of advice is not the same as the provision of products – each investment consulting firm should ideally seek to add value in a way that reflects its own beliefs about what is important.

That said, an initial framework would not need to deal with every eventuality. We would support a set of broad principles and aspirations about the purposes of the provision of data – and allowing some sensible divergence around this with suitable explanation, which we expect would evolve with time and practical use.

We are concerned that measuring all firms the same way will lead to group think and group action, less incentive for differentiation, innovation and ultimately less competition, as we mentioned in our Initial Hearing Statement to the CMA.

5. *Should any claim in relation to the impact of a firm's recommendation be subject to external benchmarking or scrutiny and should this be assessed against a common methodology for presenting impact?*

We are happy for external scrutiny and already have the performance of our manager picks externally audited. We consider this good practice, but do not believe it should be mandatory.

6. *How should any change in presentation be implemented and enforced*?

We believe that guidance should be issued to investment consulting firms, and separate guidance to trustees, as potential buyers, on what to look for and what to ask prospective consultants. This, we feel, is the best way of consultants being able to maintain their breadth and differentiation, while helping trustees identify which consultants are most suitable for their needs.

B. General comments on the analysis

We have examined the analysis covered by the working paper and have a few comments to make which we believe are worth noting:

- We stated that repeating the analysis focused on equity and bond manger picks was unlikely to show anything new, and that an increasing amount of our (and other consultants') recommendations were now focused on alternative assets, with a high percentage of equities and bonds now passively managed. However, page 27 of the working paper notes that many alternative product recommendations are excluded from the analysis. Page 57 states that 69.75% of the analysis universe covers equities and just 0.69% relates to alternatives. In our view, this calls into question the current relevance of the analysis carried out by the CMA. We note that the performance for alternatives shown is positive (i.e. contrary to the CMA's overall findings).
- Page 25 of the working paper suggests the analysis presents results of quarterly returns. If this is correct, we believe that it misses the point of long-term investing and it would be worth remembering the danger of short-term measurement, as cited by Paul Myners. Other aspects of the methodology seem reasonable.
- It is unclear to us whether the ratings that have been measured include global ratings for the larger global consultants, the vast majority of which will be of no relevance to UK pension funds and therefore little or no relevance to this review.
- It would seem very likely that the analysis on page 28 is skewed by the small number of consultants covered and the vastly different number of products rated. IC5 has 59,912 products rated per quarter whereas IC2 has just 580 and IC3 just 832. It is perhaps not surprising that the overlap measured as a percentage of the total number of rated products is low. In practice, we expect the overlap of products recommended and used by UK pension funds is far higher than suggested by the CMA's analysis and an alternative analysis would easily demonstrate this.
- We note that on page 57 there is no time period given for what the average active return is measuring, making it difficult for readers to interpret the figures.

- Excluding Mercer due to them not subscribing to eVestment does seem to us to be a fairly major exclusion from the analysis universe.

April 2018